86-1412

NO.

Supreme Court, U.S.
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IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1986

SANFORD ROSENBLOOM and
SANFORD ROSENBLOOM AS EXECUTOR OF THE
ESTATE OF DAVID B. ROSENBLOOM, DECEASED,

Petitioners,

v.

BENJAMIN ROTHBERG,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTIONS PRESENTED

1. Should the limitations that this Court placed on the *in pari delicto* defense in *Bateman Eichler, Hill Richards, Inc. v. Berner*, 105 S.Ct. 2622 (1985), be made applicable to common law breach of contract actions that are in federal court solely because of diversity of citizenship?

2. In order to succeed on a defense that the obligation sought to be enforced by the plaintiff arose out of an illegal transaction, must the defendant show:

(a) that the plaintiff was more culpable than the defendant (or is it sufficient to show that the plaintiff bore at least substantially equal responsibility for the violations of law); and

(b) that denial of the defense would significantly interfere with the effective enforcement of the law (or is it sufficient to show that preclusion of plaintiff's suit would not significantly interfere with the effective enforcement of the law)?

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT[1]

Petitioners respectfully pray that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Third Circuit entered in this case on December 29, 1986. The court of appeals decision raises important questions regarding the scope and meaning of this Court's decision in Bateman Eichler, Hill Richards, Inc. v. Berner, 105 S.Ct. 2622 (1985) and, in view of Erie Railroad v. Tompkins 304 U.S. 64 (1938) and the Rules of Decision Act, 28 U.S.C. § 1652, the extent to which the limitations that Bateman Eichler placed on the in pari delicto defense should be made

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1. All parties to the proceeding are listed in the caption. No corporations are involved.

applicable to common law breach of contract actions that are in federal court solely because of diversity of citizenship.

OPINIONS BELOW

The December 29, 1986 opinion of the court of appeals (App. 1a-29a) is unreported. The district court opinion which the court of appeals reversed (App. 33a-97a) is reported at 628 F. Supp. 746 (E.D. Pa. 1986).

The district court's earlier bench opinion (App. 117a-126a) is unreported. The opinion of the court of appeals remanding that earlier decision (App. 98a-116a) is reported at 771 F.2d 818 (3d Cir. 1985).

STATEMENT OF JURISDICTION

The judgment of the court of appeals was entered on December 29, 1986 (App. 1a-29a). A timely petition for rehearing was denied on January 27, 1987 (App. 30a-32a). The district court had jurisdiction over this matter under 28 U.S.C. §1332(a), plaintiff being a citizen of New Jersey and defendants being citizens of Pennsylvania and the requisite amount being in controversy. This Court has jurisdiction to review the judgment of the court of appeals under 28 U.S.C. §1254(1).

STATUTES AND RULES INVOLVED

The Rules of Decision Act, 28 U.S.C. § 1652, provides:

> "§ 1652. State laws as rules of decision
>
> "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply."

Rule 52(a) of the Federal Rules of Civil Procedure provides, in pertinent part:

> "Rule 52. Findings by the Court
>
> "(a) Effect. ...Findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses...."

STATEMENT OF THE CASE

This common-law breach of contract action was commenced in the United States District Court for the Eastern District of Pennsylvania in May 1983 by respondent Benjamin Rothberg ("Rothberg"), a New Jersey resident who had been the financier of insider trading deals that had taken place in 1969. Jurisdiction was based on diversity of citizenship, 28 U.S.C. § 1332(a). Rothberg sought to recover on two promissory notes that had been issued to him to back up guarantees against losses on those insider trading deals. Rothberg had extracted those guarantees from David Rosenbloom ("David"), the insider and a Pennsylvania resident. The smaller of the two notes was for $135,000. and was signed by David. The larger note

was for $441,050 and was signed by David's younger brother, Sanford (also a Pennsylvania resident), and was guaranteed by David. The defendants were Sanford, who is a respected real estate lawyer (and a partner in the Philadelphia law firm of Schnader, Harrison, Segal & Lewis), and David (who died on May 12, 1985). Sanford and David defended on the ground that the two notes were unenforceable because the obligations had arisen out of illegal transactions between David and Rothberg.

After a three-day bench trial in June 1984, the trial judge (District Judge Marvin Katz) ruled that the notes were unenforceable because they arose out of transactions wherein Rothberg had knowingly traded on insider information in violation of law. In his bench opinion (App. 117a-126a), the trial judge found that

Rothberg and David had been involved in a joint venture scheme to profit from inside information that David possessed and that the two notes arose out of those illegal transactions. The trial judge also specifically found in that bench opinion that "Sanford did not know the shares bought by the two joint ventures were purchased on the basis of David's inside information until about the time this suit was brought" (App. 123a), which was some 14 years after the inside trading had taken place. Basing his decision on his factual findings and on his application of the Third Circuit's decision in Tarasi v. Pittsburgh National Bank, 555 F.2d 1152 (3d Cir.), cert. denied, 434 U.S. 965 (1977), the trial judge decided to deny relief to Rothberg and to "let the parties before me stand where the market left them" (App. 122a).

In September 1985, a Third Circuit panel (Circuit Judges Gibbons and Higginbotham and District Judge Sarokin) upheld the trial judge's factual determinations -- the court of appeals opinion characterizing David as "a knowing 'tipper'," Rothberg as "a knowing 'tippee'," and Sanford as "an innocent bystander" (App. 109a). Although that 1985 panel held that "the trial court's findings of fact on the insider trading issue are not clearly erroneous" (App. 111a), it nevertheless remanded the matter for further proceedings because, "during the pendency of the instant action...the vitality of our Tarasi rule has been questioned by the United States Supreme Court in Bateman Eichler, Hill Richards, Inc. v. Carl F. Berner, et al., 53 U.S.L.W. 4737 (No. 84-679, June 11, 1985)" (App. 110a).

The Bateman Eichler case was a private action for damages under the securities laws in which the plaintiffs claimed that they had been fraudulently induced to purchase stock as a consequence of false and misleading information that corporate insiders and a broker-dealer pretended was accurate inside information. Holding that the in pari delicto defense did not necessarily bar the plaintiff's action, this Court said in Bateman Eichler that "a private action for damages in these circumstances may be barred on the grounds of the plaintiff's own culpability only where (1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of suit would

not significantly interfere with the effective enforcement of the securities laws and protection of the investing public." 105 S.Ct. at 2629. After quoting this passage from Bateman Eichler, the Third Circuit's 1985 panel said:

> "Obviously, the district court did not have this passage from the Bateman Eichler opinion before it when it made its factual findings and conclusions of law. Accordingly, we feel it appropriate to remand this matter to the trial court to make factual findings as to 1) whether Rothberg bears at least 'substantially equal responsibility' for the violations he seeks to redress, and 2) whether preclusion of suit would 'significantly interfere' with the effective enforcement of the securities laws and protections of the investing public" (App. 110-111a).

On remand, the trial judge carefully reviewed the record, analyzed the evidence, and issued a lengthy opinion containing, inter alia, 54 separately-numbered Findings of Fact (App. 33a-97a).

From his detailed review of the evidence, the trial judge found, inter alia: that "from the beginning of these joint ventures, Rothberg relied on David's insider tips" (Finding 36, App. 61a); that "the joint ventures sprang from Rothberg's desire to make more money for himself" (Finding 42, App. 63a); that "Rothberg also financed the joint ventures [and] without his participation the joint ventures could not have come about" (Finding 44, App. 65a); that "Sanford was unaware of the illegal insider trading until about the onset of the litigation" (Finding 45, App. 65a); and that "Rothberg bears at least substantially equal responsibility with the defendants for the illegal conduct from which the notes and guarantee in this suit derived" (Finding 48, App. 67a). The trial judge also went further

and found in this 1986 opinion that, "as the instigator and the financier of the joint ventures, Rothberg's culpable conduct fairly outweighs that of David and Sanford. . . . In effect, Rothberg and David were co-conspirators to violate the securities laws against insider trading" (Finding 49, App. 68a). The trial judge held that these findings satisfied the first prong of the Bateman Eichler test.

Turning to Bateman Eichler's second prong, the trial judge found that "barring Rothberg from recovery here would enhance, not interfere with, the effective enforcement of the securities laws and would more likely protect the investing public than enforcing these contracts, spawned from greed and nurtured by crooked insider dealing" (Finding 52, App. 69-70a).

On December 29, 1986, a new third circuit panel (Circuit Judges Rosenn, Seitz and Sloviter) set aside the trial judge's findings and directed that judgment be entered for Rothberg on the two notes.[2] The majority of this new panel (Judges Rosenn and Seitz) concluded (1) that the first prong of the Bateman Eichler test had not been met in this case because there was insufficient evidence in the record to support the trial judge's findings that Rothberg was the instigator of the illegal transactions and was more culpable than David and Sanford (App. 10a-13a), and (2) that the second Bateman Eichler prong was not met here because

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2. The main burden of any judgment will fall on Sanford, who signed the larger of the two notes (the one for $441,050). David's estate lacks sufficient assets to satisfy David's guarantee of Sanford's note.

"denial of the defense here ... will have no real effect on disclosure of wrongdoing, much less 'significantly interfere with the effective enforcement of the securities laws'" (App. 15a).

Before reaching these conclusions, however, the Third Circuit's 1986 panel first had to determine whether the Bateman Eichler limitations should be made applicable to actions, such as the instant one, where the claim is a common law one and federal jurisdiction is based solely on diversity of citizenship. On this question, the court was divided, the majority (Judges Rosenn and Seitz) holding that the Bateman Eichler limitation should apply regardless of the nature of the suit and the dissent (Judge Sloviter) opining that the Bateman Eichler limitations

should have no applicability to this kind of action.

On January 29, 1987, the Third Circuit denied rehearing and rehearing in banc, with two judges dissenting (App. 30a-32a).

REASONS FOR GRANTING THE WRIT

I. EXTENDING THE BATEMAN EICHLER LIMITATIONS ON THE IN PARI DELICTO DEFENSE TO COMMON LAW BREACH OF CONTRACT ACTIONS IS UNWARRANTED AND IS INCONSISTENT WITH THE PROPER DEFERENCE THAT FEDERAL COURTS MUST AFFORD TO STATE LAW IN DIVERSITY CASES.

This is a simple common law action for breach of contract which reached the federal court solely because the plaintiff and the defendants are of diverse citizenship. The defendants (Sanford and David) raised the state law defenses of illegality and in pari delicto and, were it not for the Third Circuit's

belief that the Bateman Eichler limitations are applicable here, those state law defenses would have been successful and the lawsuit would have been barred since the claims arose out of illegal transactions. See the Pennsylvania authorities cited in the trial judge's 1986 opinion (App. 74a-78a).

However, because of the court of appeals' application of Bateman Eichler, the reverse has occurred. A case that would have died had it been brought in the state court has found life in the federal courts, an obligation that would have been unenforceable in the state court has given rise to a viable cause of action in the federal court and a plaintiff who would have found the state court doors closed will walk away with a federal judgment which, with interest, will be in excess

of $800,000.[3] Such a result turns the Rules of Decision Act (presently codified at 28 U.S.C. § 1652) and the principles of Erie Railroad v. Tompkins, 304 U.S. 64 (1938), on their head. It comes about because the court of appeals apparently believes that this mischievous result was ordained by this Court's ruling in Bateman Eichler.

Surely, that cannot be what the Court anticipated when it decided Bateman Eichler. In its opinion in that case, the Court acknowledged that the in pari delicto "defense is grounded on two premises: first, that the courts should not

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3. As noted above, the main burden of that judgment will fall on Sanford, even though he was found to be an innocent bystander who was unaware of the illegal insider trading until the onset of the litigation.

lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality." 105 S.Ct. at 2626-27. The Court's opinion did not evidence any disagreement with those salutary premises or their usual consequences.

However, the Court found a countervailing consideration in Bateman Eichler that influenced it to restrict use of the in pari delicto defense in actions to recover damages for violations of federal law. That countervailing consideration was the need to encourage private suits that serve important public purposes, such as suits designed to punish persons who make fraudulent misrepresentations in violation of the securities laws (as was the case in Bateman Eichler) and suits to enforce the antitrust laws (as was the

case in Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968), where the Court had sharply restricted the availability of the in pari delicto defense in antitrust actions).

No such countervailing considerations are present in common law breach of contract actions like the instant one. Suits by people like Rothberg who seek to recover on obligations that they have entered into as part of illegal transactions serve no public purpose whatsoever. The plaintiffs in those suits do not seek to enforce the securities laws or the antitrust laws or any other federal legislation; to the contrary, those plaintiffs seek to avoid the impact of the legislation by invoking federal jurisdiction solely on the basis of diversity and then asking the federal courts to disregard

applicable state law and to enforce obligations arising out of transactions into which they entered in knowing violation of the law, obligations that the state courts ordinarily would refuse to enforce because of their illegal birth. The policy considerations that led to the Bateman Eichler limitations on the in pari delicto defense are in no way present in such a case.

On the other hand, there are fundamental judicial policies which are present and which require that an action such as this should have the same outcome whether it is adjudicated in a state court or in a federal court. The First Congress passed the Rules of Decision Act to ensure that civil remedies fashioned by a state would be equally respected and enforced by federal courts adjudicating state-based claims, so that different

results would not obtain for the same claim merely in consequence of the accident of the parties citizenship. Erie and its progeny have invoked and evolved these fundamental principles in varying contexts to ensure that common law remedies in diversity actions are applied in an equitable fashion regardless of the parties' citizenship. See Erie, 304 U.S. at 75; Klaxon v. Stentor Electric Manufacturing Co., 313 U.S. 487, 496 (1941). As stated in Guaranty Trust Co. v. York, 326 U.S. 99, 109 (1944), Erie "expressed a policy that touches vitally the proper distribution of judicial power between the state and federal courts."

Erie and subsequent decisions were intended to discourage forum shopping by eliminating the possibility that a choice of forum would depend on whether

federal or state common law is more favorable, and to avoid inequitable administration of the law solely because of the parties' citizenship. Hanna v. Plumer, 380 U.S. 463, 467 (1964).

In Erie, this Court rejected a mischievous doctrine that had "prevented uniformity in the administration of the law of the state." 304 U.S. at 75.[4] The

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4. In Erie, the Court wrote (304 U.S. at 74-75):

> "...[T]he mischievous results of the doctrine [of Swift v. Tyson] had become apparent. Diversity of citizenship jurisdiction was conferred in order to prevent apprehended discrimination in state courts against those not citizens of the State. Swift v. Tyson introduced grave discrimination by non-citizens against citizens. It made rights enjoyed

(Footnote continued on next page)

decision of the court of appeals in the instant case restores that kind of mischief by making the outcome of the case vary depending on whether suit is brought in state court or federal court. The approach taken by the court of appeals should be rejected because, as the Court said in Erie, "except in matters governed

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> under the unwritten 'general law' vary according to whether enforcement was sought in the state or in the federal court; and the privilege of selecting the court in which the right should be determined was conferred upon the non-citizen. Thus, the doctrine rendered impossible equal protection of the law. In attempting to promote uniformity of law throughout the United States, the doctrine had prevented uniformity in the administration of the law of the State." (Footnote omitted.)

by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the state." 304 U.S. at 78.

II. THE COURT OF APPEALS' MISINTERPRETATION AND MISAPPLICATION OF THE FIRST PRONG OF THE BATEMAN EICHLER TEST ESTABLISHES BAD PRECEDENT.

Even if the Bateman Eichler limitations on the in pari delicto defense were properly applicable to a common law breach of contract action, the decision below would still warrant review by this Court because of the bad precedent it establishes as a consequence of the court of appeals' misapplication and misinterpretation of Bateman Eichler's two-prong test.

In Bateman Eichler, this Court said that the first factual determination

that a court must make in order to ascertain whether the in pari delicto defense is available in a given case is whether "the plaintiff bears at least substantially equal responsibility for the violations." 105 S.Ct. at 2629. In the instant case, the trial judge specifically made such a factual determination (Finding 48, App. 67a), but he then went further and found that the plaintiff (Rothberg) bore "more than substantially equal responsibility;" the trial judge found that Rothberg was the "instigator" and, therefore, bore greater responsibility than both defendants (Finding 49, App. 68). The court of appeals reversed that determination and directed entry of judgment in Rothberg's favor because the majority could "find no evidence to support the district court's finding that Rothberg

'instigated' the scheme to trade on insider information" (App. 12a). But whether Rothberg "instigated the scheme" should not have been the dispositive question. The key inquiry under Bateman Eichler should be whether the record supports the trial judge's finding that "Rothberg bears at least substantially equal responsibility with the defendants for the illegal conduct from which the notes and guarantee in this suit derive" (Finding 48, App. 67a).

Had the court of appeals addressed that question insofar as it pertains to Sanford, it would have had to conclude that the answer is yes. The facts regarding Sanford's innocence were not even questioned. The trial judge had found in his 1984 bench opinion that Sanford did not know until suit was brought

in 1983 that the 1969 transactions had involved inside information (App. 123a); the 1985 court of appeals panel had accurately referred to Sanford as an "innocent bystander" (App. 109a); and the trial judge had found on remand in 1986 "that Sanford was unaware of the illegal insider trading until about the onset of the litigation" (Finding 45, App. 65a) Those findings were fully supported by the record since Sanford had testified that it was not until shortly before suit was filed that he learned of the insider trading (NT 1.43), and David had confirmed that Sanford lacked knowledge of the

insider trading (NT 1.107, 1.146 and 1.159).[5]

Because of its misinterpretation and misapplication of the first prong of the Bateman Eichler test the court of

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5. As to David's comparative guilt, there were factual disputes. For example, there were numerous instances of inconsistencies in testimony between Rothberg and David. But the trial judge, as fact finder, chose to reject Rothberg's version of those facts and to accept David's version (Findings of Fact 17, 25, 28, 32, 42, App. 48a, 52a, 55a, 57a, 63a). The court of appeals opinion did not make any reference to the trial judge's resolution of these factual disputes in David's favor.

   Obviously the court of appeals weighed the evidence regarding David differently than did the trial judge. However, it is the trial court, not the court of appeals, that is supposed to resolve factual disputes and makes factual determinations. See Fed. R. Civ. P. 52(a) and Anderson v. City of Bessemer 105 S.Ct. 1504, 1511-12 (1985).

appeals not only has set a bad precedent; it also has reached a result that will permit a knowing violator of the securities laws to recover hundreds of thousands of dollars from an innocent bystander who was unaware of the illegal insider trading until the onset of this litigation. Surely, this Court never intended that Bateman Eichler would lead to such an unconscionable result.[6]

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6. One reading the 1986 court of appeals opinion may notice a passing statement that is inconsistent with the notion that Sanford was the innocent bystander that the trial judge (on two occasions) and the court of appeals (in its 1985 opinion) found him to be. We refer here to a statement in the 1986 court of appeals opinion that the illegal "scheme originated with David, his brother, and his close friend" (App. 13a) (emphasis supplied). The reference to the "brother" in that statement has absolutely no support in the record.

(Footnote continued on next page)

III. THE COURT OF APPEALS' MISINTERPRETATION AND MISAPPLICATION OF THE SECOND PRONG OF THE BATEMAN EICHLER TEST ESTABLISHES BAD PRECEDENT.

In Bateman Eichler this Court said that a plaintiff who bears at least substantially equal responsibility for the violation may be barred from recovery where "preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public." 105 S.Ct. at 2629. It is hard to imagine how preclusion of suit in breach of contract cases like the instant one could significantly interfere with the effective enforcement of those laws. The instant

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> Through an inadvertent slip of the pen, the court of appeals sullied Sanford's reputation and tainted him with his brother's sins.

action is not one for enforcement of the securities laws, or any other laws for that matter. All that Rothberg and people like him are trying to enforce are obligations that they entered into as a part of their own illegal transactions. Allowing Rothberg and his ilk to recover in cases such as this would not amount to enforcement of the securities laws; and denying them recovery would in no way interfere with enforcement of the securities laws.

In his 1986 opinion, the trial judge commented that denying relief in this case would probably discourage insider trading by people like Rothberg (App. 92a). The court of appeals did not disagree with that comment but said that it did not see how denial of recovery would significantly aid in the effective enforcement of the

securities laws. The court of appeals' final word on the subject was:

> ". . .Denial of the defense here thus will have no real effect on disclosure of wrongdoing, much less 'significantly interfere with the effective enforcement of the securities laws'" (App. 15a).

In making this statement, the court of appeals demonstrated either a failure to understand, or an unwillingness to follow, the second prong of the Bateman Eichler test. The court of appeals' statement turns that prong upside down. The question that Bateman Eichler poses is not whether denial of the defense will significantly interfere with the effective enforcement of the securities laws; the question is whether preclusion of the plaintiff's lawsuit will significantly interfere with enforcement of those laws. 105 S.Ct. at 2629.

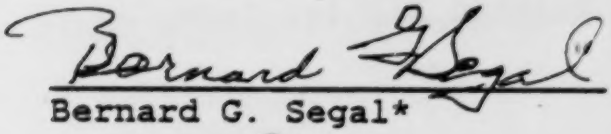
Precluding a guilty participant from recovering against an innocent bystander cannot constitute a significant interference with the effective enforcement of the securities laws.

Only review by this Court can give meaning to the second prong of the Bateman Eichler test.

CONCLUSION

For the foregoing reasons, a writ of certiorari should be granted to review the judgment of the United States Court of Appeals for the Third Circuit.

Respectfully submitted,



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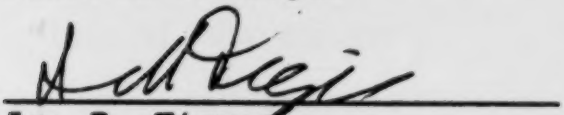

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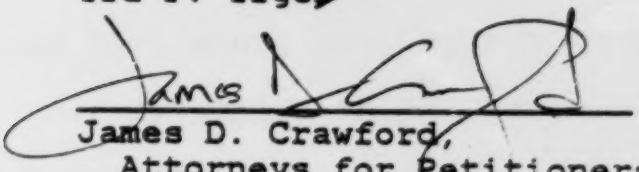

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A P P E N D I X

CORRECTED COPY

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

NO. 86-1120

BENJAMIN ROTHBERG,

Appellant

v.

SANFORD ROSENBLOOM and SANFORD ROSENBLOOM as EXECUTOR OF THE ESTATE OF DAVID B. ROSENBLOOM, DECEASED,

Appellees

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA
D.C. Civil No. 83-2387

Argued September 18, 1986
Before: SEITZ, SLOVITER, and ROSENN,
Circuit Judges
Opinion Filed December 29, 1986

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JUDGMENT OF THE COURT

ROSENN, *Circuit Judge*.

Plaintiff Benjamin Rothberg sought payment in this diversity action on two promissory notes, each executed by one of the defendants. The defendant David Rosenbloom guaranteed the note executed by defendant Sanford Rosenbloom, and all instruments were dated February 7, 1979. In answers filed by each of the defendants, they made no challenge to the validity of the notes and the guarantee, but asserted that the notes arose out of obligations created by agreements between the parties in 1969 to engage in transactions prohibited by section 10(b) of the Securities Exchange Act of 1934 as amended and Rule 10-5 of the Securities Exchange Commission promulgated thereunder.

After a bench trial, the district court found that the promissory notes had their genesis in two of several joint ventures formed by the parties some ten years before for the purpose of trading on insider information contrary to law. It therefore denied Rothberg relief on an *in pari delicto* theory, relying on this court's decision in *Tarasi v. Pittsburgh National Bank*, 555 F.2d 1152 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977).

Rothberg appealed to this court, contending that *Tarasi* did not control because the suit was brought on

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the notes only, not for redress of a securities laws violation. Before a decision was rendered on that appeal, the Supreme Court overruled *Tarasi* in *Bateman Eichler, Hill Richards, Inc. v. Berner*, U.S. , 105 S. Ct. 2622 (1985), which rejected the general availability of the *in pari delicto* defense to tippers of securities information sued by their tippees. This court therefore remanded Rothberg's suit for reconsideration of the *in pari delicto* defense in light of *Bateman Eichler*. *Rothberg v. Rosenbloom*, 771 F.2d 818 (3d Cir. 1985).

On remand, the district court, on the basis of the original record, held that although *Bateman Eichler* bars the *in pari delicto* defense in most suits by tippees against their tippers, this case fell within an exception set forth in that opinion, and that the *in pari delicto* defense was therefore available to the Rosenblooms. Furthermore, the court held that Pennsylvania law did not bar a separate defense of illegality, specifically disclaimed by the Rosenblooms, because enforcement of the notes would offend public policy. Accordingly, the court again entered judgment for the defendants. Rothberg appeals this judgment. We reverse.

I.

A brief description of the cast of characters in the scenario before us is helpful. Plaintiff Benjamin Rothberg is a chemist and cofounder of Montrose Chemical Company. He also served as a director of the publicly held Mallory Randall Corporation for one year.[1] David Rosenbloom, an officer and director of several corporations prior to his death, served as chairman of the executive committee and a director of Nytronics,

1. Rothberg had apparently stepped down from the board of Mallory Randall prior to his purchase as a joint venturer of its securities.

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Inc., a publicly held corporation, from 1967 through 1973. He also was a member of the control group, a salaried executive, and a director of Mallory Randall from 1968 through 1976. A graduate of the Wharton School of the University of Pennsylvania, David had twice attended but never completed law school. His brother, Sanford, is a practicing lawyer since 1955, specializing in real estate. Benson Selzer, not a party here, is a registered representative for a New York securities brokerage firm. A close friend and business associate of David, Selzer was part of the group (including David) which acquired control of Nytronics. He served as a vice-president and director of both Nytronics and Mallory Randall. Rothberg and David met when a corporation controlled by David, Centlivre Brewing Co., merged with Montrose Chemical. David introduced Rothberg to Selzer, who subsequently became Rothberg's stock broker.

In 1968 and 1969, Rothberg entered into six "joint ventures" with either Sanford or David. All but the first of these joint ventures were formed to trade on inside information available to David or Selzer as officers or directors. Rothberg, not an insider, advanced about $1,365,000 for these joint ventures, with the co-venturer (either David or Sanford) contributing only $100 each time. Under the agreements, the co-venturer had the power to sell the securities involved. If the investments were profitable, all profits were to be shared equally. If the investments lost money, however, Sanford was to indemnify Rothberg for any losses. David executed a separate guaranty for this indemnification agreement.

The first three ventures yielded profits, which were shared according to the agreement. The fourth resulted in a loss, for which the Rosenblooms accordingly indemnified Rothberg. The last two ventures, involving investments in Mallory Randall

Corporation and Gulton Industries, also resulted in losses. This time, the Rosenblooms did not reimburse Rothberg.

In 1972 Rothberg agreed to extend the joint ventures and not to sue for indemnification. In return for this forbearance, Sanford gave him a demand note, guaranteed by David. In a contemporaneous letter, prepared by David, the Rosenblooms waived any defenses, counterclaims, or set-offs to the note. In 1979, the Rosenblooms, still not having paid the note, entered into an arrangement with Rothberg to give him two new notes for a liquidated sum at a reduced rate of interest and Rothberg agreed not to sue on the earlier note. Rothberg's suit on these notes and the guarantee are the subjects of this appeal.

II.

On appeal, Rothberg argues first that the district court erred in allowing an *in pari delicto* defense, because that defense is unavailable to the defendants under the general rule of *Bateman Eichler, Hill Richards, Inc. v. Berner,* U.S. , 105 S. Ct. 2622 (1985), and because the exception to that rule does not apply here. Second, he asserts that the trial court erred in holding that under Pennsylvania law the notes were unenforceable because they were related to a transaction illegal under federal law and offended public policy.[2]

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2. The district court addressed the defense of illegality under Pennsylvania law and concluded that it supplied an alternative basis for denying relief. The court held as a matter of law that the notes would not be enforced because the underlying transactions upon which they were predicated offended public policy as being "part of a plan between Rothberg and David to violate federal securities laws." 628 F. Supp. at 755.

We see no need to consider the defense of illegality under Pennsylvania law because the public policy, even as alluded to by

The *in pari delicto* defense is related to the illegality defense in its goal of deterring wrongdoing and its policy of denying judicial relief to wrongdoers. Prior to the Supreme Court's decision in *Bateman Eichler, Hill Richards, Inc. v. Berner, supra*, the circuits had disagreed whether the *in pari delicto* defense was available to tippers in securities litigation.[3] Some courts held that the defense's inconsistency with effective enforcement of the insider trading prohibitions of the securities acts outweighed its usefulness in tipper-tippee actions. *See, e.g., Nathanson v. Weis, Voisin, Cannon, Inc.*, 325 F. Supp. 50, 53 (S.D.N.Y. 1971). Others, including this court, felt that "the prophylactic impact on the use of inside information that allowance of the defense will lead to" predominated over the deterrence value of nonrecognition of the defense. *Tarasi v. Pittsburgh National Bank, supra*, 555 F.2d at 1163. *Tarasi* had

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the district court, is one that underlies federal securities law, not Pennsylvania law. Therefore, the analysis with respect to the illegality defense is governed by federal law, not state law. *See* Shadis v. Beal, 685 F.2d 824, 822 (3d Cir.), *cert. denied*, 459 U.S. 970 (1982); Sola Electric Co. v. Jefferson Co., 317 U.S. 173, 176 (1942). Furthermore, as this court has held that *Bateman-Eichler* controls, although it addresses the *in pari delicto* defense and not illegality, the policy it presents is also relevant to the illegality defense. It is premised on the assumption that allowing disappointed tippees to seek tippers is ordinarily the better means of discouraging insider trading.

3. *See, e.g.*, Tarasi v. Pittsburgh National Bank, 555 F.2d 1152 (3d Cir.) (allowing defense), *cert. denied*, 434 U.S. 965 (1977); Malamphy v. Real-Tex Enterprises, Inc., 527 F.2d 978 (4th Cir. 1975) (per curiam) (allowing defense only in some circumstances); Keuhnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969) (allowing defense at court's discretion); Mallis v. Bankers Trust Co., 615 F.2d 68 (2d Cir. 1980) (defense rejected), *cert. denied*, 449 U.S. 1123 (1981).

been the controlling authority for this circuit at the time of the original trial in the case at bar. Before this court issued its opinion in the first appeal, however, the Supreme Court resolved the conflict in *Bateman Eichler, Hill Richards, Inc. v. Berner*, U.S., 105 S. Ct. 2622 (1985).

In *Bateman Eichler*, the Court noted that the *in pari delicto* doctrine had always required a careful consideration of public policy implications before allowing the defense. *Id.* at , 105 S. Ct. at 2628. "[I]mplied private actions," continued the Court, "provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'" *Id.* (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)). Denial of the defense best promotes protection of the investing public because (1) allowing suits by a defrauded tippee will expose wrongdoers and facilitate civil, administrative, and criminal action; (2) placing pressure on insiders will maximize the deterrence of insider trading; (3) insiders are usually more responsive to the pressures of potential sanctions; and (4) tippees are deterred by means other than the *in pari delicto* defense. *Id.* at , 105 S. Ct. 2631-33. Furthermore, the Court observed that it had "eschewed rigid common-law barriers in construing the securities laws." *Id.* at , 105 S. Ct. at 2628.

The Court therefore rejected the *in pari delicto* defense to implied causes of action brought by a tippee against a tipper under the federal securities laws generally, stating the rule in terms of its own two-prong exception:

> [A] private action for damages in these circumstances may be barred on the grounds of the plaintiff's own culpability only where (1) as a direct result of his own actions, the plaintiff bears

> at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public.

Id. at , 105 S. Ct. at 2629. Rejecting the *Tarasi* rule, *id.* at , 105 S. Ct. at 2631, the Court concluded that "the public interest will most frequently be advanced if defrauded tippees are permitted to bring suit and to expose illegal practices by corporate insiders . . . ." *Id.* at , 105 S. Ct. at 2633.

Because of the possible application of the *Bateman Eichler* exception, a previous panel of this court remanded this case to the district court specifically for the purpose of making factual findings under the new standard announced in that case. *Rothberg v. Rosenbloom*, 717 F.2d 818, 824 (3d Cir. 1985).[4] Our primary inquiry thus becomes whether the factual findings[5] made by the district court support its conclusion that Rothberg bore at least substantially equal responsibility in the underlying illegal

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4. Unlike *Bateman Eichler*, which was a section 10(b) suit for securities fraud, Rothberg sued on the promissory notes and guarantee. In light of the previous decision of this court, the question whether the *Bateman Eichler* decision applies to these facts is not addressed.

5. As an appellate court, our duty is to accept the ultimate factual determinations of the fact-finder unless they are clearly erroneous. Fed. R. Civ. P. 52(a). "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." United States v. Gypsum Co., 333 U.S. 364, 395 (1948). This court has consistently been at least as deferential to trial courts' findings of fact as the *Gypsum* standard requires. *See, e.g.*, Krasnov v. Dinan, 465 F.2d 1298 (3d Cir. 1972).

transactions. We also consider the legal question of the potential effect upon the investing public of precluding this suit.

Only one other circuit has construed *Bateman Eichler*. In *Dahl v. Pinter*, 787 F.2d 985 (5th Cir. 1986), the Fifth Circuit gave the extent to which the plaintiff's illegality must outweigh the defendant's before the threshold in the first prong of *Bateman Eichler* is met.[6] That court held that the *in pari delicto* defense applies "'only where some *unconscionable* act of one coming for relief has immediate and necessary relation to the equity that he seeks in respect of the matter in litigation.'" *Id.* at 988 (quoting *Keystone Miller Co. v. General Excavator Co.*, 290 U.S. 240, 245 (1933)) (emphasis added by the court). The court rejected the tipper's *in pari delicto* defense to the tippee's action under § 12(1) of the Securities Act of 1933.[7]

The Rosenblooms assert that in order to come within the *Bateman Eichler* exception they need only have shown that Rothberg bears at least substantially equal responsibility for the violations of law involved. This is a gross misstatement. First, it ignores entirely the existence of the second prong of the *Bateman Eichler* test. Second, the first prong of the test requires substantially equal responsibility for the violations *that the plaintiff seeks to redress*: here, the plaintiff

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6. In itself, this part of the test appears to be inconsistent with the doctrine of *in pari delicto* itself, which by its own name requires only a finding equal fault on the part of the plaintiff, not an analysis of relative fault. *In pari delicto* is a corollary of the equitable "unclean hands" doctrine, which demands not even equal fault.

7. In *Dahl*, the tippee, a full time real estate investor, and others had knowingly purchased unregistered securities and sought recission under section 12(1) when the investment soured. The circuit court affirmed the district court's decision in the investors' favor.

seeks to redress only the nonpayment of the last set of notes executed in 1979, not any of the insider transactions. *See In re Olympia Brewing Co. Securities Litigation*, 1986 Fed. Sec. L. Rep. (CCH) ¶ 92,461 (N.D. Ill. 1985). The Rosenblooms' quotation of only half of the rule and their alterations of its language distort the Court's meaning almost to the point of inversion.

In support of its conclusion that the first prong of the *Bateman Eichler* test is met, the district court characterized Rothberg as the "instigator" of the insider trader scheme:

> Although Rothberg did not come up with the specific details of the plans to trade on inside information, it was his pressure on David to come up with a means to make Rothberg more money, in short, his greed, that led to the scheme to trade on inside information . . . .

628 F. Supp. at 752-53. This unrealistically presupposes that the tippees contemplated by *Bateman Eichler* are not motivated by "greed," although it is difficult to imagine what motivations other than a desire "to make . . . more money" compel them.

Even assuming that instigating and financing the joint ventures amount to "substantially equal responsibility" under *Bateman Eichler*, it is far from obvious that Rothberg "instigated" these transactions. David Rosenbloom and Selzer, as officers and directors of Nytronics, possessed the inside information, not Rothberg. They had primary responsibility to their principals, and it was they who breached their fiduciary duty to that company. David Rosenbloom's own testimony shows that it was he and Selzer who proposed the scheme to Rothberg, not the other way

around.[8] Furthermore, Sanford Rosenbloom's answer to Rothberg's complaint states that the debts' purpose was "to *induce plaintiff* . . . to engage in transactions specifically prohibited by section 10(b) of the Securities Exchange Act of 1934 . . . ." (Emphasis added).

David Rosenbloom, the possessor of the inside information, was empowered to act for Rothberg and the others, and himself stood to profit; he did not merely pass along information. The Rosenblooms' contention that Rothberg's request that they provide him with some way of making money to recompense for his assistance in acquiring control of two publicly held companies somehow forced them to divulge inside information is weak indeed. Certainly, they had a *reason* to give Rothberg information, whether it was compensation for his assistance or, more likely, to obtain the use of his money to finance their schemes. A reason for a proposal is not duress. Rothberg's "greed" is no more relevant than the Rosenblooms' own.

Finally, far from supporting the finding that Rothberg was the instigator of the scheme, there is no

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8. David Rosenbloom testified, inter alia:

Q: What did you and Mr. Seizer do after Mr. Rosenbloom expressed these sentiments [his interest in making some money]?

A. We talked about it a lot; we thought about it a lot. We talked about it again, thought about it again. There just didn't seem to be any way . . . . *However, Mr. Seizer came up with an idea, which he explored first along with me, [of] allowing Mr. Rothberg to participate through inside information in two deals in which he would not participate and one in which I would not participate. That would be a way to make Rothberg some money and at the same time make some money for ourselves.*

628 F. Supp. at 757, n.7 (emphasis added by district court).

explanation for what appears to be an additional inducement to Rothberg's participation: the Rosenblooms' agreement to assume the risk of all losses. This indemnification feature makes the scheme look less like an investment and more like a loan from Rothberg to the Rosenblooms and Seizer, to allow the Rosenblooms and Seizer to make much bigger investments on inside information than their own and Seizer's funds permitted, with the *quid pro quo* for the loan being one-half of any profits reaped.[9]

We have reviewed the record and we can find no evidence to support the district court's finding that Rothberg "instigated" the scheme to trade on insider information. The evidence is to the contrary.

The district court characterized Rothberg, from its observation of his testimony, as "an astute, sophisticated and intelligent businessman, extremely careful about detail," *id.* at 758, attributes generally found in most successful and not necessarily overbearing business persons. Although couched as a finding, the court's observation that the plaintiff's "culpable financing of these illegal schemes can fairly be said to outweigh David's weakness in furnishing tips" is actually nothing more than a conclusional statement, not entitled to deference on review. *Id.* at 758. But does such a conclusion bear any rational relationship to the record? An analysis of David's "weakness" reveals that it was nothing more or less than the desire to make money -- the same characteristic or "weakness" that motivated Rothberg.

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9. The trial judge apparently perceived the arrangement between Rothberg and David Rosenbloom as a loan, for in his analysis of the enforceable warranty theory he contemplated "that the David Rosenblooms of this world would be encouraged to borrow money for inside trading if they had a 'warranty' that they did not have to pay back their lenders." 628 F. Supp. at 758.

The district court attempted to portray David, based on his testimony, as "a weak and dependent tout," but this description is not borne out by the record. David, having graduated from the Wharton School of the University of Pennsylvania and having attended law school, had a history as a successful business entrepreneur. He had served as chairman of the executive committee and a director of Nytronics, Inc. for a half dozen years. He had been a salaried executive, director, and member of the control group of the Mallory Randall Corporation for eight years. Moreover, he had available to him the counsel and services of his brother, a practicing lawyer, and of his close friend, business associate, and securities broker, Benson Selzer.

We perceive nothing in this record that shows Rothberg dominated David's will or exercised any undue influence over him. The evidence demonstrates nothing more than a simple scheme on the part of David and his colleagues to trade on inside information relating to David's corporations. The information indisputably came from David, not Rothberg. The scheme originated with David, his brother, and his close friend. Their objective, like Rothberg's, was profits; they all shared in them. The Rosenblooms succeeded in having Rothberg advance his money to finance their share of the investments. The Rosenblooms' reliance on Rothberg's loan may be seen by the district court as "dependence"; others may see it as good business judgment, but for the participants' insensitivity to the illegality of the enterprise. We are of the firm belief that the district court's findings relating to the first prong of the *Bateman Eichler* exception are not supported by the evidence and are clearly erroneous.

The second *Bateman Eichler* prong requires a determination that "preclusion of suit would not

significantly interfere with the effective enforcement of the securities laws and protection of the investing public." This determination is a matter of policy and our review is plenary. Although the district court concluded that this prong had been met, its reasoning suggests the opposite conclusion.

The district court's opinion strains to distinguish the facts in the case at bar to avoid the rule of *Bateman Eichler*. Because Rothberg, the tippee, was the financier, the court reasoned that denying him relief would "probably discourage insider trading by cutting off the transaction at its root, money." 628 F. Supp. at 758. It is unclear why money, not access to inside information, is the "root." Far from distinguishing the Rothberg-Rosenbloom-Selzer transactions from those addressed by *Bateman-Eichler*, this tippee/financier-tipper/advisor scheme is likely to be the typical, not the exceptional pattern. It certainly seems easier for insiders to find unaware or even unscrupulous investors than for investors to find unscrupulous or careless insiders. Furthermore, in this case the tippers themselves, as well as the tippee, stood to make a profit on the inside information.

Similarly, we are not persuaded by the Rosenblooms' attempt to distinguish this case on the basis that there was a "conspiracy"; although the scheme was collusive, it seems to have been no more so than any other tipper-tippee arrangement. Moreover, the Supreme Court noted that tippers are likely to "be more responsive to the deterrent pressure of potential sanctions; they are more likely than ordinary investors to be advised by counsel." U.S. at . 105 S. Ct. at 2632. Sanford Rosenbloom himself is a practicing lawyer of many years, although his specialty is real estate, not securities law. Finally, because the beneficiaries of the duty imposed by § 10(b) are the

investing public, common sense suggests that insiders, not tippees, are in the more critical position to abuse the access they enjoy.

The district court added that denying the *in pari delicto* defense to the Rosenblooms would fail to advance the *Bateman Eichler* goal of exposing wrongdoing, because in the case at bar the tipper himself is trying to bring the fraud to light. We disagree. First, the statute of limitations had run for any public enforcement of the securities laws in this case. Second, and more important, this reasoning ignores the fact that the Rosenblooms exposed the wrongdoing only as a defense to Rothberg's suit on the notes. If tippees in his position do not sue their tippers because they know they can be precluded from recovery by the *in pari delicto* defense, then we can expect that their tippers will never expose the wrongdoing as did the Rosenblooms. Denial of the defense here thus will have no real effect on disclosure of wrongdoing, much less "significantly interfere with the effective enforcement of the securities laws."

Thus, the second prong of the *Bateman Eichler* test has not been met. We therefore hold that it was error to make the *in pari delicto* defense available to the defendants.

III.

In sum, the facts of this case do not bring it within the exception to the *Bateman Eichler* rule; the *in pari delicto* defense is thus unavailable to the Rosenblooms.

Accordingly, the judgment of the district court will be reversed and the case remanded with directions to enter judgment on the notes in favor of the plaintiff against the defendants.

Costs taxed against defendants.

SEITZ, *Circuit Judge*, concurring.

Although I join in the judgment reversing the district court, I write separately because, unlike Judge Rosenn, I am willing to assume that the decision of this court on the prior appeal in this case does not foreclose us from deciding whether *Bateman Eichler, Hill Richards Inc. v. Bernet et al.*, ___ U.S. ___, 105 S. Ct. 2622, 86 L.Ed.2d 215 (1985), applies to a contract action.

The Supreme Court announced what I read as a general rule in *Bateman Eichler, supra*, that a defense of *in pari delicto* may not be asserted by a tipper in a damage action by a tippee under Rule 10(b)-5. However, the Court indicated that there could be what may be denominated as an exception to that rule under certain circumstances. Here the district court held that based on its findings of fact the exception applied and the defense of *in pari delicto* barred plaintiff Rothberg's diversity action seeking judgment on two promissory notes.

I emphasize at the outset that although this is a diversity action, the doctrine of *Erie Railroad v. Tompkins*, 304 U.S. 64, 58 S. Ct. 817, 82 L.Ed. 1188 (1938), is not applicable to defenses raised under federal law. As the Supreme Court has explained,

> When a federal statute condemns an act as unlawful, the extent and nature of the legal consequences of the condemnation ... are ... federal questions, the answers to which are to be derived from the statute and the federal policy which it has adopted. To the federal statute and policy, conflicting state law and policy must yield.

Sola Electric Co. v. Jefferson Electric Co., 317 U.S. 173, 176, 63 S.Ct. 172, 174, 87 L.Ed. 165 (1942) (holding that local laws of estoppel are not applicable where the defense asserted in a diversity contract action is based on federal law); *see also Kelly v. Kosuga*, 358 U.S. 516, 519, 79 S. Ct. 429, 431, 3 L.Ed.2d 475 (1959). In the light of such law, and my assumption as to our prior decision, the first issue presented on appeal is whether the policies that led the Supreme Court generally to reject the *in pari delicto* defense in Rule 10(b)-5 actions by tippees against tippers should lead to a rejection of the defense in a contract action based on obligations arising out of the illegal transaction.

The *Bateman Eichler* decision rests on two distinct policy determinations. First, the Supreme Court found that a tipper who breaches his or her fiduciary duties is more culpable than a tippee who trades on the information. ___ U.S. at ___, 105 S.Ct. at 2630-31, 86 L.Ed.2d 215. Second, the Supreme Court found that "deterrence of insider trading most frequently will be maximized by bringing enforcement pressures to bear on the sources of such information--corporate insiders and broker dealers." ___ U.S. at ___, 105 S.Ct. at 2632, 86 L.Ed.2d 215. In short, the Supreme Court held that the purposes of federal securities laws generally will be furthered by barring the use of the *in pari delicto* defense in actions by tippees against tippers under Rule 10(b)-5.

Whether the action is brought in contract, as here, or under Rule 10(b)-5, I believe that permitting a tippee to recover against a tipper, and thus barring the *in pari delicto* defense, will further the policies enumerated by the *Bateman Eichler* Court. First, allowing recovery by

the tippee regardless of the form of the action will reinforce the notion that tippers are more culpable than tippees. Second, by holding tippers liable, they will be further deterred from breaching their fiduciary duty.[1] Therefore, in my view, the form of the action is not controlling, at least so long as the subject matter arises out of the wrongdoing of the parties or their privies.

But defendants contend, and the district court found, that the exception noted in *Bateman Eichler*[2] applies and renders the *in pari delicto* defense controlling. Since the correctness of this ultimate determination turns on the facts and inferences therefrom, the next major issue is whether, as Rothberg contends, the critical findings of fact made by the district court on this issue are clearly erroneous. On this phase of the case I agree completely with Judge Rosenn's position that based on this record one can only reasonably conclude that such findings are

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1. The district court apparently believed this second statement to be untrue because a tippee could wait until after the statute of limitations had run for federal violations before bringing the contract action. One benefit of permitting Rule 10(b)-5 actions by tippees is that these actions will bring violations to the SEC's attention. *Bateman Eichler*, ___ U.S. at ___, 105 S. Ct. at 2631-32, 86 L.Ed.2d 215. I do not believe, however, that this benefit was the determinative factor in the *Bateman Eichler* opinion. Rather, I read the Court to be more concerned with deterring tippers by imposing sanctions on them than with simply providing the SEC with an additional means of discovering violations.

2. The Court said that where the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress and preclusion of the action would not significantly interfere with effective enforcement of the securities laws and protection of the investing public the defense would be available.

mistaken. I say this with a full realization of the rigorous restraints imposed on our review by F.R. Civ. P. 52(a).

In light of the foregoing analysis, I agree with Judge Rosenn that the general rule of *Bateman Eichler* is controlling. Accordingly, I join in the judgment reversing the judgment of the district court.

SLOVITER, *Circuit Judge*, dissenting.

I respectfully dissent from the judgment of the court reversing the dismissal of this action and directing the district court to enter judgment for plaintiff Benjamin Rothberg. I cannot accept the legal analysis in Judge Rosenn's opinion announcing the judgment of the court because I believe that this is not a case governed directly by the holding in *Bateman Eichler, Hill Richards, Inc. v. Berner*, 105 S. Ct. 2622 (1985). Although my approach to this case is not markedly different from that taken in Judge Seitz' opinion concurring in the judgment, I evaluate the relevant public policy considerations differently.

I.

Whether Bateman Eichler *is Controlling*

Rothberg's suit to recover from the Rosenblooms on notes signed by them was brought as a diversity action based on contract law. The Rosenblooms defended, *inter alia*, on the ground that the promissory notes derived from obligations which were legally unenforceable because they grew out of transactions involving trading on insider information in violation of the federal securities laws. The notes represented an indemnity by the Rosenblooms, who

were the insiders, *i.e.*, the tippers, against loss by Rothberg, the tippee, on joint venture transactions that Rothberg funded in stock of companies that would be affected by the inside information. The district court found that the transactions were in fact illegal and this court affirmed those findings. 771 F.2d 818 (3d Cir. 1985). The illegality of those insider trading transactions is thus established for purposes of this appeal.

The legal question before us is the effect of the illegality for purposes of Rothberg's right to recover from his joint venturers on their indemnity. Judge Rosenn's opinion is predicated on the applicability of the holding in *Bateman Eichler* to the facts before us despite the significantly different circumstances under which *Bateman Eichler* arose. In *Bateman Eichler*, the Supreme Court had before it a Rule 10(b)-5 private action brought by tippees against their tipper; it held that tippers could not defend that action on the basis of the *in pari delicto* defense. The Court recognized that the defense would nonetheless be available in certain limited circumstances even in Rule 10(b)-5 actions.

Nothing in that decision suggests that its holding applies to suits other than those under the securities law. Justice Brennan meticulously described the question presented as whether the common-law *in pari delicto* defense bars a private action "under the federal securities laws" against corporate insiders. 105 S. Ct. at 2624. The Court rejected the tipper's argument that the holding of *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), denying the *in pari delicto* defense in antitrust actions, was inapplicable to securities actions because Congress had not expressly provided for such actions. Instead, the Court concluded "that the views expressed

in *Perma Life* apply with full force to implied causes of actions under the federal securities laws." 105 S. Ct. at 2629. Judge Rosenn points to no language in the opinion extending the holding to contract actions based on illegal securities transactions.

Judge Rosenn suggests that "this court has *held* that *Bateman Eichler* controls," Rosenn Op. Typescript at 6 n.2 (emphasis added), and therefore he does not address the question whether the *in pari delicto* doctrine applies to these facts. *Id.* at 8 n.4. Presumably, he is invoking this court's policy precluding a subsequent panel from overruling a published opinion of a previous panel. *See* IOP Chapter 8(c), Policy of Avoiding Intra-Circuit Conflict of Precedent. If the prior panel had analyzed the applicability of *Bateman Eichler* to contract actions, and then remanded for findings, we would indeed be barred. However, although the parties filed letter briefs on the issue, *see* App. at 314, the previous panel merely stated that because the district court "did not have [a] passage from the *Bateman Eichler* opinion before it when it made its factual findings and conclusions of law," it was appropriate to remand the matter for that court to make factual findings as to "1) whether Rothberg bears at least 'substantially equal responsibility' for the violations he seeks to redress, and 2) whether preclusion of suit would 'significantly interfere' with the effective enforcement of the securities laws and protections of the investing public." 771 F.2d 818, 824. The remand suggests that the prior panel believed *Bateman Eichler* was relevant, but it should not be viewed as a decision that *Bateman Eichler* was necessarily controlling in contract actions in the absence of any statement to that effect.

We have not infrequently been troubled by the controlling force under IOP 8(c) of a prior panel's

decision remanding for further findings. *See Associated Film Distribution Corp. v. Thornburgh*, 800 F.2d 369, 377 n.3 (3d Cir. 1986). If we are to expand our policy requiring adherence to prior panel "opinions" to include matters that were not discussed in those opinions and not necessarily decided, then I believe it should be done by the full court through amendment of our Internal Operating Procedures. Until then, I believe we are free to examine a legal issue not previously reached or necessarily decided. Thus, as stated above, I believe we are free to decide that *Bateman Eichler* does not apply of its own force.

In securities litigation, as in antitrust actions, plaintiffs are acting not only on their own behalf but to supplement enforcement actions by the regulatory bodies. *Bateman Eichler*, 105 S. Ct. at 2628. It enhances the effect of such actions, and thereby the public interest, to preclude the *in pari delicto* defense inasmuch as the defense would impede successful maintenance of actions. For this reason, the Court has "eschewed rigid common-law barriers in construing the securities laws." *Id.* It simply does not follow as a matter of course from *Bateman Eichler* that common-law barriers should be likewise eschewed in common-law actions. Thus, whether the *in pari delicto* defense should be available in a contract action brought by tippees against their tippers involves a different mode of analysis than that used by Judge Rosenn.

II.

Availability of the In Pari Delicto *Defense in Contract Actions*

Judge Seitz states that federal law and federal policy should apply to determine whether the *in pari delicto* defense is available in contract actions. I do not

disagree because any right of Rothberg to recover under the state contracts law must yield to a federal policy expressed in or underlying federal law that would preclude such recovery.

Judge Seitz suggests that the same policy considerations that led the *Bateman Eichler* Court to bar a tipper's use of the *in pari delicto* defense in a Rule 10(b)-5 action would be similarly applicable in contract actions. I cannot agree.

I see two bases for the Court's decision that tippees, albeit not blameless, should be able to sue their tippers under the securities laws unencumbered by the *in pari delicto* defense. One was the Court's conclusion that a tipper who breaches his or her fiduciary duties is more culpable than a tippee who does nothing more than trade on the information. 105 S. Ct. at 2630-31. The Court said, "In the context of insider trading, we do not believe that a person whose liability is solely derivative can be said to be as culpable as one whose breach of duty gave rise to that liability in the first place." *Id.* at 2630. The culpability of the tipper defendant for Rule 10(b)-5 actions is evidenced by the rule requiring the tippee to prove the tipper acted with scienter. 105 S. Ct. at 2633 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976)). The *Bateman Eichler* Court continually stressed that the *in pari delicto* defense would be availabile if the parties were shown to have substantially equal culpability.

The second basis for the decision barring the tipper's use of the *in pari delicto* defense in Rule 10(b)-5 actions was the Court's view that the public interest would thereby be served since tippers would be deterred through encouragement of tippees' Rule 10(b)-5 actions and the consequential exposure of the underlying illegal trading.

The Court believed that measures designed to deter insider trading are more effectively addressed to tippers than tippees, particularly since prospective tippers constitute a smaller class than prospective tippees. 105 S. Ct. at 2632 and 2632 n.29 (quoting Comment, *Availability of an In Pari Delicto Defense in Rule 10b-5 Tippee Suits*, 77 Colum. L. Rev. 1084, 1096-97 (1977)). The Court also suggested that tippers as a class are more likely than tippees to be aware of the existence of legal sanctions for trading misconduct, and hence "more responsive to the deterrent pressure of potential sanctions." 105 S. Ct. at 2632. The Court recognized that there may be some disincentive to tippees to bring such actions because they will thereby also expose themselves to possible civil and criminal penalties. 105 S. Ct. at 2633. I assume that the Court believed that the incentive of monetary recovery would overcome the tippee's concern about exposure.

I suggest that any prediction of the deterrent value of the *in pari delicto* defense in contract actions involving insider trading is, at best, speculative. The Supreme Court in *Bateman Eichler* could make a hypothesis about deterrence in the context of Rule 10(b)-5 actions because such suits are typically brought by a disappointed tippee who has incurred a loss in trading based on inside information that was intentionally false or misleading. In contrast, there is no readily discernible pattern in contract actions by tippees. We do not have sufficient data through reported cases. Such actions would probably be fact-specific, depending on the nature of the contract and the conduct. If we hypothesize any pattern at all to contract actions, it is likely to be one, as in this case, where the tipper and tippee have agreed on a joint venture to trade on insider information. A breach of contract suit by a tippee may be brought on a variety of

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claims, such as failure to adhere to the contract terms, supplying false information or misappropriating the proceeds.

I am considerably less comfortable than my brethren in predicting whether disallowance of the *in pari delicto* defense to the tipper will deter such arrangements in the future. I recognize that such a defense may deter some contract actions, but I believe that the exposure of insider trading through suits between the parties is more likely to occur in federal securities actions, which have been implied for such a purpose. Public exposure of the illegal securities scheme will only occur in contract actions if the defendant tipper is permitted to raise the *in pari delicto* defense. Even if the time has passed for any sanctions under the securities laws, there is a public benefit to be gained by bringing the facts to light.

Thus, I would hold that the public policy considerations that underlay the *Bateman Eichler* holding precluding the tipper's use of the *in pari delicto* defense in securities litigation are inapplicable to the tipper's defense in a contract action arising out of a conspiracy between the tipper and tippee to misuse inside information for their mutual benefit. Since the joint venture for illegal purposes is the paradigmatic situation for application of the common law *in pari delicto* defense, I see no reason not to apply it to common law contract actions between tippees and tippers.

I turn next to the other prong of the *Bateman Eichler* analysis, the relative responsibility of the tipper and tippee. Even if we assume that the tipper is ordinarily more culpable, as the Supreme Court stated, the Court nonetheless recognized that there may be particular instances in which this is not the fact: "[S]ituations might well arise in which the relative

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culpabilities of the tippee and his insider source merit a different mix of deterrent incentives." 105 S. Ct. at 2632. The joint venture to trade on inside information is likely to be one such situation. In any event, whether the tippee bore substantially equal responsibility depends on the district court's factual findings, and I cannot agree that in this case they are clearly erroneous.

I agree with my colleagues that the written record does not support the district court's findings that Rothberg instigated the inside trading scheme and that Rothberg dominated David Rosenbloom's will or exercised undue influence over him. I recognize that the district court may have relied on impressions from the demeanor of the witnesses to which we must defer, but the findings are inconsistent with Rosenbloom's testimony that, in fact, he and Selzer, under pressure from Rothberg to make Rothberg some money, proposed the scheme to Rothberg. App. at 187. In addition, there is simply nothing in the record to indicate that Rothberg's demand for profits amounted to coercion on Rosenbloom.

However, *Bateman Eichler* does not require either instigation or coercion before the *in pari delicto* defense can be used. It merely requires "substantially *equal* responsibility." The record adduced in the district court supports a finding that Rothberg bore at least that much responsibility, even if he was not more culpable.

As the district court found, and as the record supports, Rothberg is unlike the ordinary tippee predicated in the *Bateman Eichler* opinion. He was a sophisticated investor who had served as director of public corporations and had participated in mergers and stock syndications. App. at 120, 186. Nothing suggests that Rothberg was the passive recipient of the inside information.

On the contrary, Rothberg played an active role in structuring and financing the scheme.[1] He had at least enough leverage to extract from the Rosenblooms the highly unusual indemnity against loss, thereby guaranteeing himself the very "enforceable warranty" that the *Bateman Eichler* Court found tippees would not be able to get through Rule 10(b)-5 actions. Moreover by 1979, when Rothberg obtained the promissory notes on which this suit is based, he was well aware of the illegality of insider information trading, since he had been obliged, following an SEC investigation, to disgorge the proceeds of a similar transaction. *See SEC v. Shapiro*, 349 F.Supp. 46, 48 (S.D.N.Y. 1972), *aff'd*, 494 F.2d 1301 (2d Cir. 1974). He was able to bring the present contract action without fear of criminal or civil proceedings only because he withheld filing this suit until the statute of limitations had run on any possible suit against him for securities law violations.

Although I am not persuaded by the Rosenblooms' portrayal of themselves as naive and innocent participants, neither do I see any basis for this court to view Rothberg as any less culpable.

I believe that my colleagues, in stressing the lack of evidence as to Rothberg's instigation or coercion, have

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1. Rothberg's active role in determining the terms of the agreements is evidenced by a memo from Sanford Rosenbloom concerning alterations in the agreements:

> Today I spoke to Ben Rothberg about the matter of Joint Ventures. He told me that because it was the understanding that he would pay all interest for obtaining funds for the use of the Joint Venture and because he is to be entitled to all dividend or interest income from the Joint Venture, hereafter Joint Venture Agreements should be simplified to take out the present wording about expenses and insert wording per the understanding.

App. at 331.

failed to focus on the relevant factual issue, which is whether Rosenberg was at least as culpable as the Rosenblooms. Since he was a sophisticated investor who invested in excess of $1,300,000 in the series of six insider transactions to which these notes are related, and since he was able to extract a warranty against any losses from that trading, I believe that we cannot denominate the district court's finding that he bore substantially equal responsibility as clearly erroneous.

The *Bateman Eichler* Court derived the "substantially equal responsibility" inquiry from the earlier opinions in *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968). There, the Court disallowed a franchisor from asserting the *in pari delicto* defense against an antitrust suit brought by several of its franchisees. The plurality concluded that the dealers were not equally culpable because their agreement to the illegal contract clauses was not voluntary but "solely because their acquiescence was necessary to obtain an otherwise attractive business opportunity." 392 U.S. at 139. Justice Marshall, while agreeing that mere participation in the agreement should not bar the dealers from recovering damages, asserted:

> However, if [the franchisor] could show . . . that petitioners *actually participated in the formulation of the entire agreement*, trading off anticompetitive restraints on their own freedom of action . . . for anticompetitive restraints intended for their benefit . . . petitioners should be barred from seeking damages as to the agreement.

392 U.S. at 150 (Marshall, J., concurring) (emphasis added).

As shown, Rothberg "actually participated in the formulation of the entire agreement." Where, as here, the tippee provided the financing, pressured the insiders to produce money-making schemes, participated in the structuring of the scheme and intended to profit from that scheme, he should be found to bear "substantially equal responsibility" for that scheme. When his suit is not brought for fraud under the securities laws but instead relies on a contractual warranty included in that scheme, his recovery should be barred based on the still widespread principle "that a wrongdoer shall not be permitted to profit through his own wrongdoing." *Id.* at 151.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 86-1120

BENJAMIN ROTHBERG,
Appellant,

v.

SANFORD ROSENBLOOM and SANFORD ROSENBLOOM as EXECUTOR OF THE ESTATE OF DAVID B. ROSENBLOOM, DECEASED,
Appellees.

(Civil No. 83-2387 - E. D. of Pa.)

SUR PETITION FOR REHEARING

PRESENT: GIBBONS, Chief Judge, SEITZ, WEIS, HIGGINBOTHAM, SLOVITER, BECKER, STAPLETON, MANSMANN, and ROSENN, Circuit Judges.

The petition for rehearing filed by appellees in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

Judge Sloviter would grant rehearing in banc for the reasons set forth in her dissent.

Judge Becker would grant rehearing in banc.

By the Court

/s/ Seitz
Circuit Judge

DATED: Jan. 27, 1987

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

BENJAMIN ROTHBERG	:	CIVIL ACTION
	:	
v.	:	
	:	
SANFORD M. ROSENBLOOM	:	
and SANFORD M. ROSENBLOOM	:	
as EXECUTOR OF THE ESTATE	:	
OF DAVID B. ROSENBLOOM,	:	
DECEASED	:	NO. 83-2387

MEMORANDUM

KATZ, J. February 14, 1986

In this case the financier of crooked insider trading deals seeks to recover his losses. I find him barred by illegality. I reject his attempt to turn on its head a recent decision of the Supreme Court of the United States which allows disappointed tippees to blow the whistle on their tippers. In this case, I allow the touts to blow the whistle on

the financiers of insider trading in "hot issues" of stock. I leave these co-conspirators where the market left them. Such an approach enhances the purposes of the securities laws. Future bankrollers of illegal trading are less likely to provide the wherewithal to weak insiders who sell inside corporate information for a stake in the deal. The providers of capital have an aversion to risk. My decision puts them at risk, or at least uncertainty. In the future, insider touts will have more difficulty finding rich co-venturers to fund joint ventures in crime.

Procedural History

Plaintiff Benjamin Rothberg ("Rothberg") brought this suit to enforce

two promissory notes, dated February 7, 1979. Defendant Sanford M. Rosenbloom ("Sanford") signed one of the notes, which obliges him to pay Rothberg $441,050 on demand. This note was unconditionally guaranteed by Sanford's brother, defendant David Rosenbloom ("David").[1] The other note was signed by David and obliges him to pay Rothberg $135,000 on demand.

Defendants concede that the notes and guaranty are genuine, that they were duly delivered to Rothberg, and that Rothberg made a demand for payment. Nevertheless, they have refused to honor the notes and guarantee. The defendants have proved that the notes represent obligations in two joint ventures to make secret

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1. David Rosenbloom died on May 12, 1985. Sanford Rosenbloom is the executor of David's estate.

profits from insider trading in violation of federal securities law.[2]

After a bench trial, I ruled that both notes and the guarantee were unenforceable under the defense of in pari delicto. The notes represented losses sustained as a result of illegal insider trading: Rothberg, as part of two joint ventures, traded on inside information provided by David. This Court would not aid the plaintiff to recover his losses under those circumstances, any more than if the notes were given to secure losses in a narcotics venture. Rothberg appealed,

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2. In particular, defendants proved that the underlying obligations were incurred in connection with joint ventures that violated section 10(b) of the Securities Exchange Act of 1934 as amended (15 U.S.C. ¶ 78(b)) and Rule 10(b)-5 promulgated under section 10(b) by the Securities and Exchange Commission.

contending that I had erred in finding insider trading violations and in admitting evidence of other joint ventures in which the parties had been involved. Rothberg also argued that, as a matter of law, the promissory notes and guarantee were not subject to the in pari delicto defense.

The Third Circuit affirmed my finding that the joint venturers had engaged in insider trading in violation of the securities law. Rothberg v. Rosenbloom, 771 F.2d 818, 819-23 (3d Cir. 1985). The Court also upheld admission of evidence of other similar joint ventures in which the parties engaged, under Rule 404(b) of the Federal Rules of Evidence. Such evidence was admissible to show the nature and purpose of the two joint ventures in question.

With respect to my application of the in pari delicto defense, the panel remanded the case to me in view of a Supreme Court case, issued after my opinion, which undercut the rationale of the Third Circuit decision on which I relied.

In my Bench Opinion, I found that the conduct of Rothberg in financing the joint ventures to profit secretly on tips from misappropriated inside information was of sufficient magnitude to apply in pari delicto under Tarasi v. Pittsburgh National Bank, 555 F.2d 1152 (3d Cir. 1977), cert. denied, 434 U.S. 965 (1977). On the basis of Tarasi, I found that plaintiff was not entitled to recover.

However, the more recent Supreme Court decision in Bateman Eichler, Hill Richards, Inc. v. Carl F. Berner, et al., 105 S.Ct. 2622 (1985), called into question

the Third Circuit's holding in Tarasi. Accordingly, I must make findings under the standards in Bateman Eichler.

In particular, I must make findings as to 1) whether Rothberg bears at least substantially equal responsibility for the violations he seeks to redress, and 2) whether preclusion of Rothberg's suit would significantly interfere with the effective enforcement of the securities laws and protection of the investing public. Rothberg v. Rosenbloom, 771 F.2d at 824.

For the reasons below, I find that this case presents a "different mix of deterrent incentives" from that in Bateman Eichler and that the defense of in pari delicto applies. Bateman Eichler, 105 S.Ct. at 2632. Rothberg, as the instigator and financier of the joint ventures

involved, bears "at least substantially equal responsibility" for the violations of federal securities laws which resulted in the trading losses he seeks to recoup. Id. at 2629. Moreover, precluding Rothberg will enhance, rather than significantly interfere with, the enforcement of the securities laws and will protect the investing public by encouraging whistleblowing on illegal insider trading.

FINDINGS OF FACT

1. Plaintiff Benjamin Rothberg ("Rothberg") is the payee of two interest-bearing promissory notes which he seeks to enforce. Defendant Sanford M. Rosenbloom ("Sanford") is the maker of one of the notes, which obliges him to pay Rothberg $441.050 on demand. Sanford's brother,

defendant David Rosenbloom ("David"), unconditionally guaranteed Sanford's note. Ex. P-32.

2. David is the maker of the other note, which obliges him to pay Rothberg $135,000 on demand. Ex. P-39.

3. David and Sanford do not contest that the notes and guaranty are genuine, that they were duly delivered to Rothberg, and that Rothberg made a demand for payment.

4. Rothberg, who was sixty-six at the time of trial, is a citizen and resident of New Jersey. Educated as a chemist, Rothberg worked wit his father for a series of enterprises that eventually became Montrose Chemical Corp. and then worked for Montrose's successor, Baldwin-Montrose, when Montrose merged with two other companies. Rothberg was an officer

and director of Montrose. Rothberg also served as a director of Mallory-Randall Corp. At the time of trial, Rothberg was an investor and a technical consultant for Cris Craft. N.T. 2.22-23, 2.40, 2.43-44, 2.45.

5. Defendant David Rosenbloom ("David"), who died on May 12, 1985, was a citizen and resident of Pennsylvania. He was 59 years old at the time of trial. David graduated from the University of Pennsylvania and attended two law schools without finishing the course of study at either. David had served as an officer and director of a number of corporations, including Home Products Sales Co., Centlivre Brewing Company, Harvey's Stores, Eastern Air Devices and Centlivre's successor. In the late 1960's David was a

director and Chairman of the Executive Committee of Nytronics, Inc. and held the same positions with Mallory-Randall Corp. At the time of trial, David was unemployed. N.T. 1.110-1.115, 3.45.

6. At the time of trial, defendant Sanford Rosenbloom ("Sanford") was 55 years old and was a citizen and resident of Pennsylvania. Sanford is currently a partner in a law firm, where he has been practicing since 1955. His specialty is real estate law; he has limited knowledge of federal securities laws. N.T. 1.25-28, 3.2.

7. At the times material to this litigation, Benson Selzer ("Selzer") was a registered representative with a securities brokerage firm in New York. Selzer was a personal friend and business associate of David's and was part of a

group, along with David, that acquired control of Nytronics. In addition to being employed as a stockbroker, Selzer served as a vice president and director of Nytronics, Inc. and also held the same positions with Mallory-Randall. At all times relevant to this lawsuit, Selzer as Rothberg's stockbroker. N.T. 2.28, 3.49-53.

8. Rothberg met David when Centlivre, Montrose Chemical and Baldwin merged. After the merger, the two met irregularly on business and more often, but not regularly, at social occasions. N.T. 3.47-48.

9. David became acquainted with Selzer during the time he lived in New York City and introduced him to Rothberg. N.T. 3.48-50.

10. At the time at which the two entered into joint venture agreements,

Sanford and Rothberg were barely acquainted. At trial Rothberg could only remember having met Sanford on two occasions prior to 1981. N.T. 2.74-76.

11. Prior to this action, Rothberg and David were defendants in litigation instituted by the S.E.C. in which David was alleged to have provided Rothberg and others with insider information on which Rothberg and others traded. See SEC v. Shapiro, 349 F. Supp. 46 (S.D.N.Y. 1972), aff'd, 494 F.2d 1301 (2d Cir. 1974).

12. The promissory notes and guarantee which Rothberg seeks to enforce represent acknowledgements of debts incurred in connection with the last two of six joint venture agreements executed between February of 1968 and May of 1969. Under those agreements, Rothberg invested sums totalling in excess of $1,365,000 to

purchase securities of various publicly owned businesses.

13. Under the terms of each of these joint ventures, Rothberg contributed all the capital involved, except for $100 in cash contributed by the co-venturer (either David or Sanford). Rothberg also agreed to surrender to his joint venturer of record (either David or Sanford) the power to sell the securities involved or their equivalent over specified periods of time and to share equally with that party any profits derived from the investment. However, the other joint venturer was to indemnify Rothberg against any losses sustained by the joint venture. Each joint venture was to last for two years. In substance, these were almost all ventures in crime, i.e., to trade illegally on inside information. The

ventures were structured to protect Rothberg's creditor position as their financier.

14. All of the joint ventures but the first involved purchasing securities of firms in which either David or Selzer, or both, served as officers or directors or of companies which were targets for mergers with companies in which David or Selzer, or both, were officers or directors.

15. Selzer's brokerage firm, with Selzer as its representative, handled all of Rothberg's investments in the joint ventures. N.T. 3.62-63.

THE JOINT VENTURES

I. Joint Venture of February 14, 1968

(Harsco Joint Venture)

16. On February 14, 1968, Rothberg entered into a Joint Venture Agreement with David. Ex. D-26. Rothberg contributed 10,300 shares of stock of the Harsco Corporation, worth $239,005.42. David contributed $100.00 in cash. Profits were to be evenly divided, but David guaranteed Rothberg against loss on this investment. David was to make investment decisions for the joint venture. Id. at ¶ 4.

17. Rothberg purported to recall nothing concerning the circumstances involved in this investment. N.T. 2.60. However, I credit David's version of the events surrounding this transaction. David testified that Selzer received

information that the management of Harsco was about to embark on an aggressive program of acquisitions which was likely to cause the stock to rise. N.T. 3.61-63.

18. According to Harsco's Form 10K for 1968, Harsco did in fact acquire or organize five domestic and two foreign subsidiaries in 1968. Ex. D-31.

19. This joint venture ended profitably, with over $34,000 being divided between David and Rothberg. N.T. 3.11.

II. Joint Venture of February 15, 1968
(Nytronics Joint Venture)

20. On February 15, 1968, the day after the Harsco Joint Venture Agreement was executed, Rothberg entered into a second Joint Venture Agreement, this time with

Sanford. Rothberg contributed Nytronics debentures and 600 shares of Nytronics stock. These securities had a value of $257,661.17. Sanford's only contribution to the joint venture was $100.00 in cash. Ex. D-12.

21. Under the terms of this agreement, the parties were to share profits equally, but Sanford was to indemnify Rothberg against any losses which the joint venturers suffered. Id. at ¶ 2. In addition, the agreement states that Sanford was to make investment decisions for the joint venture during its existence. The joint venture was to last for two years.

22. In addition to this written agreement, the parties had an oral understanding among themselves as to the structure of the joint venture. Rothberg testified that, in making his investment, he

did not rely on either Sanford's investment advice or Sanford's guarantee against loss. Rather he actually relied on David's investment advice and David's guarantee of Sanford's performance under the Agreement. N.T. 2.70-73. Rothberg maintained that he had a written guarantee from David against loss but could not produce one. David testified that he gave Rothberg an oral guarantee against loss, and I credited David's testimony that his guarantee was oral. N.T. 3.64, 3.67- 68.

23. At the time these investments in Nytronics were made, David was Chairman of the Executive Committee at Nytronics. He and Selzer were both directors of that concern. N.T. 2.84.

24. This joint venture was also profitable. Rothberg earned a profit of

$127,960.40, which he divided equally with Sanford. Ex. D-18.

25. Rothberg purported to have no present recollection of what led him to enter this joint venture. N.T. 2.90-92. However, I credit David's account. David testified that he and Selzer provided Rothberg with information concerning various mergers which Nytronics was contemplating and subsequently did make, but had not yet publicly announced. N.T. 3.65-67.

III. Joint Venture of December 6, 1968

(Eastern Air Devices Joint Venture)

26. The third Joint Venture Agreement, executed on December 6, 1968, involved Rothberg's contribution of $50,299.50, which consisted of 1,700

shares of Eastern Air Devices, 1,000 shares of National Tel-Tronics, and 900 shares of Gondas Corporation. Sanford, the co-venturer, contributed only $100.00 in cash. All other major provisions of this agreement were identical to those of the Nytronics Joint Venture: the joint venture was to last two years, the parties were to divide profits equally, but Sanford was to bear all losses incurred by the joint venture. The agreement also delegated investment decisions to Sanford. Ex. D.32.

27. Rothberg claimed to have no present recollection of what caused him to make these investments. N.T. 2.114. I credit David's testimony as to the circumstances surrounding this venture. David testified that he and Selzer furnished Rothberg with information concerning

Eastern Air Devices and its 80%-owned subsidiary, National Tel-Tronics. Both David and Selzer were directors and David was Chairman of the Executive Committee of Nytronics at the time Rothberg made his investments. N.T. 3.70. David and Selzer told Rothberg about a planned merger between Nytronics and Eastern Air Devices. N.T. 3.71. The public learned about this merger three days after Rothberg made his investment and entered into the Joint Venture Agreement. N.T. 2.125, Ex. D-43. Other information which David and Selzer made available to Rothberg in this connection included the corporate plan to merge National Tel-Tronics, as well as Eastern Air Devices, into Nytronics and to install the chief executive of Eastern Air Devices as the chief operating officer at Nytronics. N.T. 3.71-72.

28. With respect to the securities of Gondas Corporation ("Gondas"), Selzer and two principals of his brokerage firm, David and Oliver Grace, were directors of Gondas at the time Rothberg made this investment. Ex. D-45. According to David's testimony, which I credit, Selzer furnished Rothberg with as yet unpublished information concerning the substantially increased earnings and prospective acquisitions of Gondas. N.T. 3.72-73.

29. This joint venture was not profitable, ultimately losing $16,736.75. Although the Joint Venture Agreement stated that Sanford was to bear all losses, the record reflects that Sanford paid Rothberg only $1,736.75 while David paid Rothberg $15,000. Exs. D-48, D-49.

IV. Joint Venture Agreement of February 9, 19

(Federal Pacific Electric Venture)

30. The parties to this Joint Venture Agreement, executed on January 20, 1969, were Rothberg and Sanford. Rothberg contributed 10,000 shares of Federal Pacific Electric stock, valued at $267,312.08, to the joint venture. Sanford's contribution was $100.00 in cash. Otherwise, this joint venture was similar to the others: the venture was to last two years, the joint venturers were to divide profits evenly with Sanford bearing all losses, and Sanford was to make investment decisions on behalf of the joint venture. Ex. D-51.

31. This joint venture made $21,319.07, which the joint venturers split. Ex. D-55.

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32. Once again, Rothberg purported to have no present recollection or records which established the precise reason for his having made the investment. N.T. 2.102-03. However, I credit David's account. David testified that the investment was made because he and Selzer told Rothberg that Nytronics had begun, without public announcement, to acquire stock in Federal Pacific Electric in the hope of facilitating a merger. Nytronics did in fact acquire more Federal Pacific Electric stock and attempted to negotiate a merger. Eventually, Federal Pacific Electric concluded a merger with another company which bought Federal Pacific stock from Nytronics and from Rothberg. N.T. 3.75-77.

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V. Joint Venture of April 18, 1969

(Mallory-Randall Joint Venture)

33. The losses sustained by this Joint Venture, executed on April 18, 1969, gave rise to the note for $135,000, signed by David, which Rothberg seeks to enforce. The Joint Venture was between Sanford (as Trustee for his parents) and Rothberg. Under the terms of the agreement, Rothberg contributed 10,800 shares of stock of the Mallory Randall Corp., valued at $109,836.00. Sanford contributed $100 in cash. As in the other agreements, the venture was to terminate in two years, Rothberg and Sanford were to divide profits evenly, but Sanford, as trustee, was to bear all losses incurred by the venture. Sanford was given

the authority to make investment decisions on behalf of the Joint Venture. Ex. P-1.

34. In my Bench Opinion, I found that the joint venturers had illegally traded on inside information that David had obtained as an officer and director of Mallory Randall and provided to Rothberg.[3] The Third Circuit affirmed this finding. Rothberg v. Rosenbloom, 771 F.2d at 820-21.

VI. The Joint Venture Agreement of May 28, 1969

(The Gulton Joint Venture)

35. The losses sustained by this joint venture between Sanford and Rothberg,

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3. In particular, David informed Rothberg that Carolina Toy, a company which Mallory Randall was interested in acquiring, would have banner earnings for a particular year.

executed on May 28, 1969, gave rise to the note and guarantee for $441,050 which Rothberg seeks to enforce. This joint venture, executed by Rothberg and Sanford, was similar to the others. Under its terms, the venture was to terminate in two years, Rothberg put up all the capital, except for $100.00 in cash, and surrendered the power to make investment decisions to Sanford. Sanford was to bear all the losses but share evenly in the profits. In my Bench Opinion, I found that the joint venturers had illegally traded on inside information that David acquired as an officer and director of Nytronics and then conveyed to Rothberg.[4]

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4. Specifically, David informed Rothberg that Nytronics would merge with another company, Gulton Industries, and

(Footnote continued on next page)

Summary of Findings With Respect to the Joint Ventures

36. From the beginning of these joint ventures, Rothberg relied on David's insider tips.

37. Rothberg admitted that he had no knowledge of Sanford's investment acumen. In addition, Rothberg learned from David that Sanford's assets, net worth, income and prospects were not substantial. N.T. 2.29, 2.77-81.

38. At trial, Rothberg contended that David had provided him with

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> that Dr. Gulton would swing or deliver the votes of the board of directors of Gulton to approve the transaction on a stock for stock basis with respect to Gulton's public shareholders. Dr. Gulton himself had sold his own holdings for cash. The Third Circuit affirmed this finding. Rothberg v. Rosenbloom, 771 F.2d at 821-23.

contemporaneous written guarantees against loss for the joint ventures in which Sanford was named as co-venturer. However, Rothberg was unable to produce any contemporaneous written guarantees. David admitted that he had guaranteed Rothberg against loss in those ventures, but that these guarantees were oral.

39. At Rothberg's request, David later provided Rothberg with written guarantees, backdated to the dates of the extant joint ventures which had sustained losses. Exs. P-34, P-35. See N.T. 2.118-24, 2.174-77, 3.10-11, 3.19, 3.20-21, 3.24-27, 3.68, 3.78-79.

40. Sanford agreed to enter into all but the Harsco Joint Venture agreement (to which he was not a party) in exchange for his receiving himself or, in one instance, as trustee for his parents, a

share of any profits. In addition, David gave Sanford his oral guarantee against loss in these ventures. N.T. 1.46-51, 1.58-61, 1.91-93.

41. David and Sanford executed various extensions of the Mallory Randall and Gulton joint ventures, and, ultimately, documented the obligations which they owed Rothberg by executing various instruments, including the notes and guarantee Rothberg seeks to enforce. Exs. P-2 - P-6, P-8, P-8A, P-32, P-39; N.T. 1.55-58, 1.63-74, 1.76-79, 1.94-96, 2.35-37.

42. I credit David's version of the circumstances surrounding the formation of the joint ventures. David testified that the joint ventures sprang from Rothberg's desire to make more money for himself. Rothberg complained that he was

not making enough money from his investments in Nytronics and that David and Selzer owed him something for helping the three of them gain control of Nytronics. N.T. 3.54-55. In response to Rothberg's pressure, David and Selzer offered the scheme to provide Rothberg with inside information, and Rothberg agreed, contingent on a guarantee against loss from David. N.T. 3.56- 57; 3.60-63.

43. Although Rothberg did not come up with the specific details of the plans to trade on inside information, it was his pressure on David to come up with a means to make Rothberg more money, in short, his greed, that led to the scheme to trade on inside information by means of the joint ventures, including the Mallory Randall and Gulton deals. Rothberg negotiated the structure of the joint

ventures with the defendants. Exs. D-122 - D-126, D-128 - D-132, D-136, D-138; N.T. 3.6-10, 3.60-63.

44. Rothberg also financed the joint ventures. Without his participation the joint ventures could not have come about. Neither David nor Selzer had sufficient money of their own to invest at that time. N.T. 3.54.

45. In my bench opinion, I found that Sanford was unaware of the illegal insider trading until about the onset of the litigation. N.T. 3.125.

46. Rothberg provided the capital to finance the joint ventures. In exchange, David provided inside information and was to receive half of any earned profits. Because David knew he could not legally enter into an agreement with Rothberg to purchase the stock invested,

David appointed Sanford to receive his share of any profits earned from the joint ventures. Because of his superior bargaining position, Rothberg extracted a guarantee against loss from David. On paper, the Mallory Randall and Gulton joint ventures were between Sanford and Rothberg. However, Rothberg relied on David's tips and guarantee against loss. As Rothberg testified, Sanford's guarantee against loss was virtually worthless. But as part of the scheme, to disguise the illegal insider trading, David did not initially document his oral guarantees to Rothberg against loss. Only after the value of the stocks in question had declined in value and upon Rothberg's insistence, did David provide written guarantees against loss to Rothberg. These guarantees were backdated to the dates of

execution of the Mallory Randall and Gulton joint ventures.

47. By providing the financing which made the investments in question possible, Rothberg knowingly profited, and enabled others to profit, from inside information from which David and Selzer were legally prohibited from profiting. If Rothberg had not furnished such financing, the trades in question would not have occurred.

48. Rothberg bears at least substantially equal responsibility with the defendants for the illegal conduct from which the notes and guarantee in this suit derive. By pressuring David to find a way to get him more money, Rothberg caused the formation of the Mallory Randall Gulton joint ventures. Rothberg and David were

aware from the inception of the joint ventures that their conduct was illegal and took affirmative steps to conceal the illegality through the structure of the joint venture, the use of oral guarantees, the concealment of Selzer's role in the deals, and the use of Sanford as a straw for David.

49. As the instigator and the financier of the joint ventures, Rothberg's culpable conduct fairly outweighs that of David and Sanford. Rothberg aggressively supported the illegal ventures to trade on inside information, and his participation was active, willing, and complete. In effect, Rothberg and David were co-conspirators to violate the securities laws against insider trading.

50. Rothberg testified that he filed this suit more than thirteen years

after the Joint Venture Agreements were executed because he hoped to benefit from the inheritance which David and Sanford received after the death of their parents. N.T. 2.37-39.

51. However, Rothberg's "forebearance" from pressing the Rosenblooms to repay their debt to him stemmed from Rothberg's concern about the possibility of prosecution brought by the Securities Exchange Commission (S.E.C.). Rothberg had been the target of an S.E.C. investigation in 1971 for his alleged receipt of and use of inside information concerning proposed mergers of an entity known as Harvey's Stores, of which David was then an executive. N.T. 1.175-83.

52. Barring Rothberg from recovery here would enhance, not interfere with, the effective enforcement of the

securities laws and would more likely protect the investing public than enforcing these contracts, spawned from greed and nurtured by crooked insider dealing.

53. Permitting the parties to stand where the marker has left them serves to deter others from organizing and financing ventures to trade on inside information.

54. As I noted in my Bench Opinion, Rothberg is an astute, sophisticated and intelligent businessman, careful about detail. N.T. 3.126. David, on the other hand, was a voluble, limited person, unlikely to keep business secrets and insensitive to the requirements of law regarding the fiduciary duties and legal restrictions imposed on him as a corporate insider responsible for the money of the investing public. The unfortunate combination of Rothberg's greed and independence

in attending to details of his affairs and David's carelessness about his legal obligations leads me to believe that David Rosenbloom furnished plaintiff the inside tips which were the basis for the investment decisions of these joint ventures. I cannot believe that Benjamin Rothberg, as he contended, would turn over his business decisions to David Rosenbloom. N.T. 3.126-27.

DISCUSSION

The Illegality Defense

Rothberg argues that the defense of illegality is unavailable to the Rosenblooms under Pennsylvania law. Rothberg cites authority to the effect that a court will enforce a claim based on an illegal

contract if the plaintiff can make out his claim without reference to the illegal underlying transaction. See e.g., O'Brien v. O'Brien Steel Construction Co., 440 Pa. 375, 380, 271 A.2d 254, 256 (1970); New York & Pennsylvania Co. v. Cunard Coal Co., 286 Pa. 72, 132 A. 828 (1926); Holt v. Green, 73 Pa. 198, 200-01 (1873); Contractor Industries v. Zerr, 241 Pa. Super. 92, 97, 359 A.2d 803, 805 (1976).

Rothberg claims that he has brought suit on facially valid negotiable instruments and that the defendants have never questioned the authenticity of the notes and guaranty.[5] Therefore, he claims he

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5. The fact that the notes and guarantee are facially valid and are under seal does not free them from a defense of illegality. As I noted in my bench opinion, the Rosenblooms did not and could not waive such a defense. It

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has made out his case as Pennsylvania law requires, without reference to the underlying illegal contract.

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> would be against public policy for them to do so. Since I have found that Rothberg was aware of the illegal insider trading undertaken by the Mallory Randall and Gulton joint ventures, he did not a holder in due course. A holder in due course must take a note without notice of any defense against it or claim to it on the part of any person. 12A P.S. section 3-302(1)(c). As a participant in the plan to trade on inside information, Rothberg was on notice of the defense of illegality. See id. section 1-201(25). Because Rothberg lacks the status of a holder in due course, he takes subject to "all defenses of any party which would be available in an action on a simple contract." Id. section 3-306(b).
>
> Rothberg also claims that he has given separate and independent consideration in exchange for the notes and guarantee through his voluntary forebearance from collecting on the

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Rothberg, however, ignores a line of Pennsylvania authority holding that courts will look at the substance, not the mere form of the transactions. See e.g. New York & Pennsylvania Co. v.

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debt prior to this suit and because he reduced the rate of interest to be assessed. For these reasons, he argues, the notes are so far removed from the underlying illegal transactions that they are free from any taint. Voluntary forebearance from collecting on an unenforceable contract does not constitute the kind of separate and independent consideration that Pennsylvania law requires to free an illegal contract from the taint of a prior illegality. See, e.g., Armstrong v. Toler, 24 U.S. (11 Wheat.) 258 (1826); Kuhn v. Buhl, 251 Pa. 348, 96 A. 977 (1916); Morris Run Coal Co. v. Barclay Coal Co., 68 Pa. 173 (1871); Seidenbender v. Charles, 4 Serg & Rawle 151 (1818). Moreover, I find that Rothberg did not attempt to collect on the debt in order to allow the statute of limitations to run on the federal securities violations committed by the Gulton and Mallory Randall joint ventures.

Cunard Coal Co., 286 Pa. 72, 84, 132 A. 828, 832 (1926); Kuhn v. Buhl, 251 Pa. 348, 373, 96 A. 977, 985 (1916); Irvin v. Irvin, 169 Pa. 529 (1895). Accord Tucker v. Binenstock, 310 Pa. 254, 165 A. 247 (1933). Even where a plaintiff can prove his case without reference to an underlying illegal transaction, a court will not enforce such a contract where to do so would offend public policy. The "scope of the public policy doctrine is broader and more encompassing than the concept of illegality." Shadis v. Beal, 685 F.2d 824, 833 (3d Cir. 1982), cert. denied 103 S.Ct. 300 (1982).

In this case, I find that the Gulton and Mallory Randall joint ventures, which sustained the losses that are the basis of the notes and guarantee in question, were part of a plan between Rothberg

and David to violate federal securities laws. To enforce this agreement would violate the purpose of these laws, which is to protect the investing public. Under these circumstances, Pennsylvania law tells me to leave the parties where the market has left them:

> "What results to a contract against public policy is a total and irremediable paralysis, which leaves it absolutely without any force or effect whatever, so that it cannot, under any circumstances, be made the basis of a cause of action. The law when appealed to will have nothing to do with it, but will leave the parties just in the condition in which it finds them. If they have fully executed their unlawful contract, the law will not disturb them in the possession of what each has acquired under it. If one has executed in whole or in part, the law turns a deaf ear when he pleads for its aid to compel the other to do as much.... If the contract is still executory, the promissor is left undisturbed in the possession of the money or other property which he agreed to pay or transfer; if the contract

> has been executed, the promissee is left undisturbed in the possession of the money or other property which has been paid or conveyed to him." Pittsburg v. Goshorn, 230 Pa. 212, 227, 79 A. 505, 510 (1911); Dippel v. Brunozzi, 365 Pa. 264, 267-68, 74 A.2d 112, 114 (1950).

Regarding the defense of in pari delicto under Pennsylvania law, Rothberg contends that Sanford was "neither 'in pari' nor 'delecto.'" Plaintiff's Memorandum of Law at 8. Plaintiff's argument is a play on words. As Judge Spaeth noted, the doctrine of in pari delicto is a specific and limited application of the general principle that "'no court will lend its aid to a man who grounds his action upon an immoral or illegal act.'" Feld & Sons v. Pechner, Dorfman, Wolfee, et al., 312 Pa. Super. 125, 130, 458 A.2d 545, 548 (Pa. 1983), appeal dismissed, 504 Pa. 177, 470 A.2d 525 (1984) (quoting

Fowler v. Scully, 72 Pa. 456, 467 (1872)). Courts refuse to enforce illegal contracts or contracts made in violation of public policy to make sure that the law does now allow a wrongdoer to recover. The defense of illegality is "allowed not for the sake of the defendant, but of the law itself." Fowler v. Scully, 72 Pa. at 466; Fitzsimmons v. Eagle Brewing Co., 107 F.2d 712, 713 (3d Cir. 1939) (the court's refusal to enforce a contract in violation of public policy is not for the sake of the defendant, but to avoid aiding such a plaintiff.); F.F. Bollinger Co. v. Widmann Brewing Corp., 339 Pa. 289, 295, 14 A.2d 81, 84 (1940) (the rule preventing recovery on an illegal contract is founded on public policy, not through regard for the person who sets up such a defense.).

The "Bateman Eichler" Decision

The Third Circuit remanded this case to me to apply the in pari delicto defense that the Supreme Court formulated in Bateman Eichler, Hill Richards, Inc. v. Carl F. Berner, et al., 105 S.Ct. 2622 (1985), issued after my Bench Opinion in this case. In Bateman Eichler, a group of investors who had sustained substantial trading losses instituted a private cause of action for fraud under Section 10(b) of the Securities Exchange Act of 1934 against a securities broker and a corporate insider. The investors claimed that the broker and corporate officer had fraudulently induced them to purchase large quantities of stock in the company of the corporate officer by divulging false information about the company. The investors admitted that their purpose in

purchasing the stock was to earn secret profits on inside information. The defendants contended that the doctrine of in pari delicto barred the investors' action.

The Court rejected the arguments of the defendants, severely restricting the availability of the in pari delicto defense in private damage actions under the federal securities laws. Henceforth, the defense would be appropriate "only where (1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcment of the securities laws and protection of the investing public." Bateman Eichler, 105 S. Ct. at 2629.

The first part of the test requires weighing the relative culpability of the parties. In Bateman Eichler, the Court noted that the broker and corporate officer (tipsters) had violated their fiduciary duties by disclosing inside information to the plaintiff investors (tippees). The breach of duty by the plaintiff-investors derived from the breach of their tipsters, the broker and corporate officer. The Court reasoned that in the context of insider trading, a person whose liability is solely derivative could not be as culpable as one whose breach of duty gave rise to that liability in the first place. Id. at 2630. Thus, absent other culpable acts on the part of the tippees, as a matter of law, the actions of tippees were not of substantially

equal culpability as those of their tipsters. Id. at 2630-31.

The second part of the test requires that a court assess the effect of allowing the defense of in pari delicto on the enforcement of the securities laws and on protecting the investing public. In Bateman Eichler, the Court noted that allowing the defendants to raise the defense "would inexorably result in a number of alleged fraudulent practices going undetected by the authorities and unremedied." Id. at 2631. In addition, the Court reasoned that "deterrence of insider trading most frequently will be maximized by bringing enforcement pressures to bear on the sources of such information -- corporate insiders and broker-dealers." Id. at 2632. The Court, thus, viewed the insider-tipster as the source of the

information and of the problem. Deterrent pressures, therefore, would be placed on the tipster by limiting application of in pari delicto.

Prior to Bateman Eichler, the Third Circuit in Tarasi v. Pittsburgh National Bank, 555 F.2d 1152 (3d Cir. 1977), cert. denied, 434 U.S. 965 (1977), as well as other courts, had reasoned that without the in pari delicto defense, tippees would have an enforceable warranty to trade on inside information: If the tip were correct, the tippees would reap illicit secret profits; if the tip did not yield the expected results, the tippees could sue their tipsters to recover damages. The Bateman Eichler Court rejected the enforceable warranty theory because it "overlooks significant factors that serve to deter tippee trading irrespective of

whether the in pari delicto defense is allowed." Id. at 2633. The Court noted that the tippees who bring suit to cash in on their enforceable warranties expose themselves to civil and criminal penalties for their own illegal conduct. Id. In addition, actions brought under section 10(b) and Rule 10(b)-5 require plaintiffs to prove scienter on the part of their defendants. For this reason, tippee-investor plaintiffs will only be able to recover from tipster-defendants where the tipsters have deliberately defrauded their tippees. Such plaintiffs will not be able to bring suit merely if the tip fails to pan out. Id.

Although Bateman Eichler limits the application of the in pari delicto defense, it does not eliminate it totally. The Court recognized that "situations

might well arise in which the relative culpabilities of the tippee and his insider source merit a different mix of deterrent incentives" from those in Bateman Eichler. 105 S.Ct. at 2632. I find that this matter contains such a mix of deterrent incentives to make application of in pari delicto appropriate.[6]

With regard to the relative culpability of the parties, the facts of this case do not resemble those in Bateman Eichler. Here there is no corporate officer or broker inducing a passive and

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6. This case, unlike In re Olympia Brewing Company Securities Litigation, No. 77 C 1206 (N.D. Ill. Nov. 18, 1985), involves Rothberg's misconduct in knowingly financing the two illegal ventures at issue, which were at the core of the violation of securities laws which defendants are raising. Further, the considerations in promoting the purposes of securities law protections are totally different in this case from the situation in Olympia Brewing.

innocent person to invest on the basis of inside information. Rather, Rothberg's participation in the six joint ventures to trade on inside information (for which he advanced over $1,365,000) was active and aggressive; it was not after-the-fact participation in an insider's breach of duty. David's testimony reveals that it was Rothberg who pressured David to come up with a way for Rothberg to earn more money on his investments. That request led to the formation of the joint ventures to trade on inside information to earn secret profits.[7]

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7. In response to the questions of counsel, David testified as follows:

> Q. Well, in any event, did there come a time when you and Mr. Rothberg entered into a joint venture agreement concerning securities of Harsco Corporation and your brother and

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With the exception of the $100 in cash that Sanford contributed to the Mallory

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Mr. Rothberg entered into a joint venture agreement with respect to securities of Nytronics?

A. Yes, there came a time.

Q. Now would you tell his Honor how it came about that those joint ventures were entered into?

A. Mr. Rothberg had been very instrumental in helping put the Nytronics syndication through and he felt that he wanted to make more money. He had invested a lot of his money in tax-free securities, some of which perhaps he had sold at a loss, most of which had depreciated in value due to the rising interest rate. He was concerned to make up that loss, specifically and generally to make money, and he asked me and then I discussed the matter with Benson as to how we could make him some money and at the same time perhaps make ourselves some money.

Q. All right. Now, when --

A. He felt that I was getting a salary.

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Randall and Gulton joint ventures, it was

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Q. When you say he felt, he thought, was this something that you just surmised from looking at him or did you have discussions?

A. He said something about he had lost a lot of money in tax-frees or some money in tax-frees, due to the rise in interest rates and some he had sold, some he had kept, but he wanted to continue to make money, but he didn't want a job, and he felt that perhaps we owed him something. In fact, we did owe him something in putting -- in helping to put across the Nytronics syndication. . . .

BY MR. MONTEVERDE:

Q. What did you and Mr. Selzer do after Mr. Rothberg expressed these sentiments?

A. We talked about it a lot; we thought about it a lot. We talked about it again, thought about it again. There just didn't seem to be any way. We were always looking at companies to buy. It's very difficult to buy a company, especially when you don't have any money, and Mr. Selzer didn't have any money, I

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Rothberg's loans that fueled the activities of the ventures. His money was the

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> didn't have any money, and it just didn't seem to be any way of doing it. However, Mr. Selzer came up with an idea, which he explored first along with me, on allowing Mr. Rothberg to participate through inside information in two deals in which he would not participate and one in which I would not participate. That would be a way to make Rothberg some money and at the same time make some money for ourselves.
>
> Q. Well, did you discuss this with Mr. Rothberg?
>
> A. Yes, we discussed it with Mr. Rothberg on more than one occasion.
>
> Q. And what did he say when you proposed this to him?
>
> A. Ultimately he agreed, provided -- I felt he did not know Mr. Selzer well. The information was really inside and that he'd be guaranteed against any loss by me and he advised me to be guaranteed against any loss by Mr. Selzer.
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> N.T. 3.53-56 (emphasis added); see also N.T. 3.60-61, 3.62-63.

sine qua non of the insider trading scheme. Moreover, Rothberg's ability to extract guaranteed Rothberg and David guaranteed Sanford's guarantee.

In short, Rothberg was the instigator and financier of the scheme to trade indemnities against loss shows his superior bargaining power to David's: Sanford on insider information. Rothberg was a rich and powerful financier; David was a weak and dependent tout. Rothberg called the tune; David danced. As I noted in my bench opinion:

> "Mr. Rothberg, from my observing his testimony, is an astute, sophisticated and intelligent businessman, extremely careful about detail. David Rosenbloom, from my observing his testimony, is a voluble, limited person, unlikely to keep business secrets and insensitive to the basic requirements of law regarding the fiduciary duties and legal restrictions imposed upon him as a corporate insider responsible

> for public investors' money. The combination of Mr. Rothberg's care and interest about the details of his affairs and Mr. Rosenbloom's carelessness about his legal obligations leads me to believe that David Rosenbloom told plaintiff the inside tips which were the basis for the investment decisions of the two joint ventures. I cannot believe that Mr. Rothberg would turn over his investment decisions to a David Rosenbloom." N.T. 3.126-27.

I find that Rothberg's culpable financing of these illegal schemes can fairly be said to outweigh David's weakness in furnishing tips. See Bateman Eichler, 105 S.Ct. at 2630-31.

I also find that precluding this claim would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public. Unlike Bateman Eichler, barring this suit would not result in denying a defrauded tippee an incentive

to bring a tipper's misdeeds to light. Rather, it is the defendants here raising the fraudulent practices which would otherwise go undetected and unremedied. To encourage bringing illegal insider trading to light, at least in this case, means allowing the defendants, who borrowed money to participate in illegal ventures, to blow the whistle on their lendor, who shared illegal profits in this series of ventures trading on inside information.

Moreover, deterrent pressures in this case are probably stronger on the well-advised financier than on the marginal insider risk-taker. That is, denying recovery to a sophisticated lendor like Rothberg will probably discourage insider trading by cutting off the transaction at its root, money. If Rothberg does not get

his money back in this case, he and others like him will be less likely to do it again. Such additional deterrence is necessary, particularly in this case, because Rothberg waited so long to bring his action in order to avoid prosecution by the Securities and Exchange Commission. The parties here got a taste of S.E.C. enforcement efforts in the early 1970's. See, S.E.C. v. Shapiro, 349 F.Supp. 46 (S.D. N.Y. 1972), aff'd, 494 F.2d 1301 (2d Cir. 1974).

The insider touts of the world are less likely to be emboldened to sell tips if I let them off the creditor's hook than the insecure financiers of illegal ventures (demanding protection by notes against losses and guarantees of guarantees) are likely to be deterred by my denying their recovery.

One of the bases on which the Supreme Court rejected the "enforceable warranty" theory of the Third Circuit in Tarasi was because of the possibility of civil and criminal prosecution of a plaintiff who tries to enforce such a warranty under the federal securities laws. Bateman Eichler, 105 Sup. Ct. at 2633. In this case, however, the statute of limitations for Rothberg's civil and criminal liability under federal securities laws has run.[8]

With regard to the enforceable warranty theory, I doubt that the David Rosenblooms of the world would be encouraged

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8. The Court's other basis for rejecting the enforceable warranty theory is also inapposite here. The Court noted that actions under section 10-b and Rule 10b-5 require a plaintiff to prove scienter on the part of the defendant. Id. But Rothberg has brought a contract action to enforce two notes and a guarantee: scienter is not an essential element of his case.

to borrow money for insider trading if they had a "warranty" that they did not have to pay back their lendors. Such a concern goes too far, like the warranty theory rejected in Bateman Eichler. First, insiders who borrow to trade expose themselves to substantial civil and criminal liability. Second, only lendors who knowingly finance illegal ventures in which they participate, like Rothberg, would be barred from recovering. Finally, what drives insider trading is the expectation of profit, not the hope or expectation of avoiding repayment of a debt where even the factual basis for such a defense is uncertain at the time of trading. The David Rosenblooms of the world will probably make their decisions whether or not to engage in insider trading without considering their chance to escape liability

for repayment of the debt that finances the trading. The future financiers -- allergic to risk -- will more likely benefit from advance advice by informed counsel of the risks of financing illegal insider trading schemes than will the future irresponsible insiders of public issuers of volatile securities, who seek to profit from their position.

The Supreme Court concluded in Bateman Eichler "that the public interest will most frequently be advanced if defrauded tippees are permitted to bring suit and to expose illegal practices by corporate insiders . . . to full public view for appropriate sanctions." 105 S.Ct. at 2633. My conclusion in this case is that the public interest will best be served if the little fish are permitted to defend litigation by the big fish who finance

illegal joint ventures to trade on insider information. This view more likely will bring to light for appropriate sanctions the wrongdoing of financiers who profit from the weakness of others. Allowing Rothberg to recover would frustrate the purposes of the securities laws by rewarding well-structured greed. Denying Rothberg recovery effectuates the laws against insider trading by putting its financiers at risk.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 84-1388

BENJAMIN ROTHBERG,
Appellant

v.

SANFORD ROSENBLOOM and
SANFORD M. ROSENBLOOM, EXECUTOR
FOR THE ESTATE OF
DAVID ROSENBLOOM, DECEASED

(D.C. Civil No. 83-2387)

ON APPEAL FROM THE UNITED STATES
DISTRICT COURT FOR THE
EASTERN DISTRICT OF PENNSYLVANIA

Arugued: May 3, 1985
Before: GIBBONS and HIGGINBOTHAM,
Circuit Judges and
SAROKIN, *District Judge**

(Opinion Filed: September 9, 1985)

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*Hon. H. Lee Sarokin, United States District Judge for the District of New Jersey, sitting by designation.

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OPINION OF THE COURT

GIBBONS. *Circuit Judge*:

Benjamin Rothberg. the payee of two demand promissory notes. appeals from a judgment in favor of the makers and guarantor. One note. for $441.050. is made by Sanford Rosenbloom and is unconditionally guaranteed by his brother. David Rosenbloom. The other. for $135.000. is made by David Rosenbloom. After a bench trial the district court held that both notes were subject to the defense of *in pari delicto*. because they grew out of transactions involving trading on insider information in violation of the federal securities laws. Rothberg contends that the court erred (1) in finding insider trading violations. and (2) in admitting evidence of other insider trading activities. He also contends that. as a matter of law. the notes in issue were not subject to the *in pari delicto* defense. We affirm in part and remand in part.

I.

Insider Trading

Rothberg is a wealthy investor who. with his father. founded Montrose Chemical Company. a

successful business. and who also served as a director of another publicly held company. Mallory Randall Corporation. David Rosenbloom is a self-employed investor who. with others. from 1967 through 1976. acquired control of various publicly held corporations. most notably Nytronics. Inc.. where Rosenbloom served as chairman of the executive committee and as director from 1967 through 1973. and Mallory Randall Corporation. where Rosenbloom was a member of the control group. a salaried executive. and a director from 1968 through 1976. Sanford Rosenbloom is a member of the bar who specializes in real estate law. Benson Selzer. a registered representative for a securities broker. served beginning in 1967 as a vice president and director of Nytronics. Inc.. and beginning in 1968 as a vice president and director of Mallory Randall Corporation.

Six joint ventures were entered into between February of 1968 and May of 1969 for the acquisition of securities in various corporations. In five of these. David and Sanford Rosenbloom were designated as co-venturers. The arrangement involved advances by Rothberg totalling in excess of $1.365.000. Sanford Rosenbloom guaranteed Rothberg against loss. and David Rosenbloom separately guaranteed Sanford's guarantee. Under the terms of the joint venture agreement. the Rosenbloom share of profits was to be shared equally with Benson Selzer. or his father Harry. and the Selzer named in the specific agreement was to share equally with the Rosenblooms the undertaking to indemnify Rothberg against loss.

Three of the first four joint ventures were profitable. The fourth resulted in a loss. for which David Rosenbloom indemnified Rothberg. The last two joint ventures. which give rise to this litigation. also produced losses. These two ventures involved investments in Mallory Randall Corporation and in Gulton Industries.

A. The Mallory Randall Joint Venture

Rothberg had been a member of a group of investors led by David Rosenbloom and Benson Selzer which acquired working control of Mallory Randall in 1968. David Rosenbloom became chairman of Mallory Randall's executive committee. a vice president. treasurer and director. Benson Selzer became a vice president and director. Rothberg became a director. On April 18. 1969 Rothberg and Sanford Rosenbloom. trustee. entered into a joint venture agreement involving Rothberg's purchase of 10.800 shares of Mallory Randall stock for approximately $10 a share. Sanford Rosenbloom agreed to indemnify Rothberg and David Rosenbloom guaranteed Sanford Rosenbloom's indemnity obligation. Henry Selzer. Benson Selzer's father. agreed to indemnify the Rosenblooms for any losses which they might have to pay to Rothberg. in exchange for 50% of the Rosenblooms' share of any joint venture profit.

About the time of the April 18. 1969 joint venture. Mallory Randall stock. which in December of 1968 had been selling at 15-5/8. had declined to a range of 9-5/8 to 10-1/2. In December. 1968. Mallory Randall had contracted to purchase a toy manufacturer. Carolina Toy. for a price of 10 times Carolina's 1968 earnings plus additional cash contingent on Carolina's net earnings. up to a maximum purchase price of $21.500.000. When Carolina's net earnings for 1968 were reported. they were more than double what had been projected. and it became necessary for Mallory Randall to raise $4.2 million additional dollars by a private placement. Mallory Randall made a public announcement of Carolina Toy's 1968 earnings and of the terms of its private placement of bonds. some of which were convertible into common stock.

One week before the April 18. 1969 joint venture agreement. David Rosenbloom and Benson Selzer

learned from the Vice President of Sales of Carolina Toy that orders for the current year. 1969. substantially exceeded those for the prior year. and that this was particularly so with respect to Carolina's largest retail customers. David Rosenbloom confirmed same by looking at certain orders on the books at Carolina Toy and by conversing with Carolina sales people and with certain Carolina customers. No public announcement was made of the anticipated increase in Carolina's 1969 revenues prior to the time the joint venturers bought the 10.800 shares of Mallory Randall stock. During 1969. Mallory Randall's net income increased from $17.787 to $1.620.718: this increase was attributable almost entirely to the earnings of Carolina Toy.

By the end of May. 1969. the Mallory Randall stock price rose to 12-3/8. Thereafter. however. because Mallory Randall management was involved with Nytronics. Inc.. which experienced a series of reversals after June of 1969. the price declined. As a result of this decline the joint venture lost $107.836.

Rothberg contends that purchase of the 10.800 shares by the April 18. 1969 joint venturers did not involve insider trading in violation of the federal securities laws. His theory is that although David Rosenbloom was an insider. the information which he acquired prior to April 18. 1969 about orders on the books at Carolina Toy was immaterial as a matter of law. The trial court found:

> The other tip was that a toy company would have banner earnings for a particular year. That tip was based on inside information which David had a duty not to reveal to the plaintiff. The information was based on his factual inside knowledge of the toy company's activities during the year in question. It was not based upon merely a guess or a prediction.

> A reasonable investor in Mallory Randall would consider the information about the 1969 earnings on its Carolina toy subsidiary to be objective. valuable. material knowledge of how much Mallory Randall would earn in the year in question. The only reason the joint venture purchased the Mallory Randall stock was because of David's tip that the Carolina toy company would have a smashing earnings year.

A-415. Rothberg urges that this finding of materiality is unsupported by the evidence. in that while David Rosenbloom testified about *orders*. his prediction about *earnings* was only that. To the extent that Rothberg's challenge is to the factual determination of materiality we reject it. Unquestionably a factfinder could draw the reasonable inference that a reasonable investor would see the obvious connection between increased revenues and the likelihood of increased profits. The finding that a reasonable investor would consider the sales information to be "objective. valuable. material knowledge of how much Mallory Randall would earn in the year in question" is not clearly erroneous. Fed. R. Civ. P. 52(a).

Relying on *S.E.C. v. Texas Gulf Sulphur Co.*. 401 F.2d 833. 851 (2d Cir. 1968). *cert. denied*. 394 U.S. 976 (1969). Rothberg urges that he was free to act on his educated guess or prediction as to future Mallory Randall earnings without having to disclose those educated guesses or predictions. The insurmountable difficulty with that argument is that the joint venturers did not act on the basis of a guess or prediction. They acted on the basis of hard information about orders on the books at Carolina Toy. The best proof of the materiality of that information is that the joint venturers. themselves experienced investors. found it to be sufficiently material to form the joint venture and

to purchase Mallory Randall stock when it was depressed in price. *Id.* at 851. As the Supreme Court has held:

> What the standard [of materiality] does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of a reasonable shareholder.

TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). That standard has been established with respect to the Carolina Toy information.

Thus we hold that the trial court did not err, factually or legally, when it found that the Carolina Toy 1969 sales information was material, and that the insiders should not have used it to the disadvantage of sellers in the market who were unaware of it.

B. The Gulton Joint Venture

On May 28, 1969, a joint venture agreement was made between Rothberg and Sanford Rosenbloom, with a guaranty of Sanford's indemnity agreement by David Rosenbloom, and an agreement by Harry Selzer that in exchange for half of the Rosenblooms' profits he would participate in the indemnification of Rothberg. Three weeks before May 28, a public announcement was made that Nytronics had contracted to purchase approximately 20% of the stock of Gulton Industries from Dr. Gulton, its founder, and his family, for $35 a share: $12 million in cash and $10.75 million in secured notes. Nytronics proposed to follow up by submitting an offer to purchase the remaining stock of Gulton solely for securities of Nytronics, but having a value of at least $35 a share.

David Rosenbloom and Benson Selzer were both Nytronics insiders. In their capacity as officers of Nytronics. Rosenbloom and Selzer learned from Dr. Gulton that he believed he controlled the Gulton Board of Directors and would persuade the Board to support a Nytronics proposal for the purchase of the remaining Gulton shares outstanding on a securities for securities basis. Because of Nytronics' financial position. the price which Gulton shares. in Nytronics securities. could be expected to command was expected to be very favorable. Dr. Gulton's representation about his supposed ability to control the decision of the Gulton Board was disclosed to Rothberg. and the joint venture agreement followed. Rothberg made the required investment in Gulton stock.

The anticipated joint venture profit never materialized. because. as it turned out. Dr. Gulton had overestimated his influence on the Gulton Board. Because he had not advised the other members of that Board of his intention to sell his stock to Nytronics before doing so. some Board members opposed. and eventually blocked. the proposed Nytronics-Gulton merger. That left Nytronics with no cash and a minority position in Gulton. As a consequence. the market reacted adversely on both stocks. Nytronics was obliged to sell its Gulton position at a large loss. and Gulton stock declined. The joint venture lost $443.894.50

The trial court found:

> One tip was [that] a company called Nytronics. of which David Rosenbloom was an officer and director. would make a profitable merger with Gulton. Although there was some publicity about the proposed acquisition of Gulton. the key secret information which David

transmitted to the plaintiff was that Dr. Gulton would swing or deliver the votes of the Gulton board to approve the transaction on a stock for stock basis as the Gulton public shareholders. Dr. Gulton having sold his own holdings for cash. David as an insider had a duty to his own corporation not to reveal this key secret to selected persons for the purpose of buying Gulton stock.

• • •

The purchases on the basis of such inside information would reinforce the feeling of the Gulton board that there was in fact a strong market for Gulton's shares which would make the merger price unattractive at a time when David's corporation was trying to woo Gulton. Whether or not David breached a duty to Gulton's shareholders, it is sufficient for this purpose that he breached a duty to his own corporation to establish a violation of securities laws under the definitions in [*United States v. Newman*, 664 F.2d 12 (2d Cir. 1981)].

A-414-15.

Rothberg contends that the district court erred with respect to the Gulton joint venture in two respects. He contends, first, that the information obtained by David Rosenbloom from Dr. Gulton was not material, in that when it was obtained the investing public knew, or at least had access to knowledge, that Nytronics proposed to make a securities for securities offer. The district court found, however, that knowledge of Dr. Gulton's expected influence on the board in favor of the proposed merger would have actual significance in the deliberations of a reasonable shareholder. As with the Mallory Randall

transaction. that finding is supported by proof that the joint venture itself acted upon the information.

Rothberg's second contention with respect to the Gulton transaction is that because he was an outsider of Gulton. whose stock was traded. as a matter of law he could not have violated Section 10(b). 15 U.S.C. § 78(b) (1982). In advancing this argument Rothberg relies principally upon *Chiarella v. United States*. 445 U.S. 222 (1980). holding that a financial printer who gains information about a proposed transaction does not violate Section 10(b) by trading in the stock of a party to that transaction. *Chiarella* is not apposite. for the printer violated no fiduciary duty to either party to the underlying proposed transaction. In this case David Rosenbloom and Benson Selzer were fiduciaries to Nytronics. a party to the underlying proposed transaction. and owed that corporation a duty not to disclose secret information which would cause others to buy Gulton stock. thereby making it more difficult for Nytronics to consummate a merger on favorable terms. The same contention made by Rothberg in this case was rejected by the court in *United States v. Newman*. 664 F.2d 12. 17 (2d Cir. 1981). a criminal prosecution for violation of Section 10(b) by insiders in a tender-offer in the purchase of stock of the target. An insider on either side of proposed transaction violates the insider trading rule when he uses insider information in violation of the fiduciary duty owed to the corporation to which he owes a duty of confidentiality.

Thus. we hold that the trial court did not err. factually or legally. when it found that the information about Dr. Gulton's supposed influence over the Gulton board was material. and that David Rosenbloom and Benson Selzer were insiders.

II.

Evidence of Other Transactions

Rothberg urges that a new trial should be granted because the trial court admitted evidence concerning the four other joint ventures in which the parties engaged, each of which also involved the use, for the advantage of the joint venturers, of insider information. Evidence of other crimes is admissible to show "motive, opportunity, intent, preparation, plan, knowledge, identity or absence of mistake or accident." Fed. R. Evid. 404(b). Intent, knowledge, and absence of mistake were relevant for establishment of the "equal fault" element of the *in pari delicto* defense. It is true that for purposes of the *in pari delicto* defense "a court may look only to conduct associated with the transaction before it, and may not forbid recovery on account of a plaintiff's activities in another setting." *Tarasi v. Pittsburgh Nat. Bank*, 555 F.2d 1152, 1157 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977). The trial court did not, however, apply the defense on account of the other transactions, but relied on the other joint ventures as evidence of the nature and purpose of the joint ventures to trade in Mallory Russell and in Gulton stock. For that purpose, the evidence was clearly admissible, and supported the court's finding that Rothberg and the Rosenblooms entered those joint ventures with a knowing purpose of trading on insider information.

III.

The *In Pari Delicto* Defense

We now turn at last to the trial court's resolution of the *in pari delicto* defense. At the conclusion of the trial, the judge issued a bench opinion. App. 413-18a.

in which he concluded that Rosenbloom had indeed communicated "secret information" to Rothberg regarding Dr. Gulton's promise to persuade the Gulton Board to vote for a stock merger. Similarly, Rosenbloom was found to have told Rothberg about the "banner earnings" Carolina Toy expected in 1969. The trial judge considered Rosenbloom to be a knowing "tipper," Rothberg to be a knowing "tippee," and Sanford to be an innocent bystander. App. 413-18. The court concluded:

> The two joint ventures which lost money for which plaintiff seeks to recover in this case were part of what appears to be a plan for investments on speculations between the plaintiff and David Rosenbloom to make profits from David's tips based on inside information. Some of the other joint ventures were indeed very profitable. The conduct of plaintiff in financing these joint ventures to profit secretly on tips from misappropriated inside information is of sufficient magnitude to apply *in pari delicto* under the *Tarasi* case to protect the purposes of the federal law regulating securities transactions for the benefit of investors. The purpose of letting the parties before me stand where the market left them is to deter others from financing ventures to make secret profits from tips of corporate insiders.

A-415-16. The "*Tarasi* case" to which the district judge refers above is *Tarasi v. Pittsburgh National Bank*, 555 F.2d 1152 (3d Cir. 1977), *cert. denied*, 434 U.S. 969 (1977). In *Tarasi* a "tippee" attempted to recover under Section 10(b) for misinformation given by a "tipper." This court, distinguishing *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), held that the Section 10(b) suit was barred by the equal

wrongdoing of the tippee in making use of the illegal but inaccurate tip. 555 F.2d at 1156-62.

During the pendency of the instant action, however, the vitality of our *Tarasi* rule has been questioned by the United States Supreme Court in *Bateman Eichler, Hill Richards, Inc. v. Carl F. Berner, et al.*, 53 U.S.L.W. 4737 (No. 84-679, June 11, 1985). In *Bateman Eichler, supra*, the Supreme Court refused to allow an *in pari delicto* defense to bar "a private damages action under the federal securities laws against corporate insiders and broker-dealers who fraudulently induce investors to purchase the securities by misrepresenting that they are conveying material non-public information about the issuer." 53 U.S.L.W. at 4738. In *Bateman Eichler* the Supreme Court appears to establish a new two-pronged standard for the use of the *in pari delicto* defense, the defense being limited to only two situations:

> [A] private action for damages in these circumstances may be barred on the grounds of the plaintiff's own culpability only where (1) as a direct result of its own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public.

53 U.S.L.W. at 4740.

Obviously, the district court did not have this passage from the *Bateman Eichler* opinion before it when it made its factual findings and conclusions of law. Accordingly, we feel it appropriate to remand this matter to the trial court to make factual findings as to 1) whether Rothberg bears at least "substantially equal responsibility" for the violations he seeks to redress.

and 2) whether preclusion of suit would "significantly interfere" with the effective enforcement of the securities laws and protections of the investing public.

IV.

Conclusion

The trial court's findings of fact on the insider trading issue are not clearly erroneous and the insider information utilized by the joint venturers was material as a matter of law. The court did not err in admitting evidence of other similar joint ventures. As to the *in pari delicto* defense, however, the district court's findings of facts were not focused on the subsequently announced test of *Bateman Eichler, Hill Richards, Inc. v. Berner, et al., supra*. Accordingly, we feel it appropriate to remand this case to the trial court for determination of factual findings under the new standards expressed therein. The judgment, therefore, will be vacated and the case remanded for further proceedings.

A. LEON HIGGINBOTHAM, JR., *Circuit Judge*, concurring.

Though I am in complete agreement with the majority's disposition of this case, I write separately to note my reservations regarding their analysis of the Gulton transaction. I agree that the joint venture violated Rule 10b-5 by trading in Gulton stock with the benefit of undisclosed material nonpublic information, but I reach that conclusion by a rather different route.

Under *Chiarella v. United States*, 445 U.S. 222 (1980), trading on material nonpublic information does not run afoul of Rule 10b-5 unless the trader violates some specific duty to "disclose or abstain" from using the information in that way. Typically, that duty arises because of the trader's role as a fiduciary of the corporation whose shares are traded. As the majority recognizes, however, that is not the case here. No one involved in the joint venture was a Gulton "insider." Rather, the majority holds that the "breach of duty" element is supplied by the fact that Rosenbloom and Selzer gave their information to the joint venture, in violation of their fiduciary duties as directors of Nytronics, a corporation that was seeking to acquire control of Gulton. Under this theory, it seems to me, there would be no 10b-5 violation had Rosenbloom and Selzer simply used their information on behalf of Nytronics, because then there would have been no breach of their fiduciary duty. Though this would undoubtedly have been more desirable from the point of view of Nytronics' shareholders, I do not see how it would matter to the investing public at large whether it was the joint venture or Nytronics that reaped the benefits of trading on this information. If the investing public is no worse off because the joint venture, rather than Nytronics, traded on material nonpublic

information. then for purposes of Rule 10b-5 this is a difference that makes no difference.

I believe the majority is attempting to bring this case within what Professor Loss has called the "misappropriation or breach-of-fiduciary-duty-to-a-third-person theory." L. Loss. *Fundamentals of Securities Regulation* 867 (1983). Under such an approach. which was approved by four justices in *Chiarella.*[1] and left open by the others.[2] one may be liable for trading on nonpublic information if that information was initially entrusted to the trader by a third party for a legitimate purpose and then "misappropriated" by the trader for personal gain. Thus. the possibility was left open that Chiarella. who was entrusted by his clients with nonpublic information regarding planned tender offers in his capacity as a printer of financial documents. could be liable under 10b-5 for using that information to his personal advantage in securities transactions. Similarly. in *United States v. Newman.* 664 F.2d 12 (2d Cir. 1981). *cert. denied.* 104 S. Ct. 193 (1983) -- upon which the majority relies -- employees of an investment banking firm were. in the course of their duties. privy to information regarding their client's tender offer plans. They were held to be liable under 10b-5 for misappropriating that information for their personal gain.

In *Newman* and *Chiarella* the traders. arguably. violated an "insider's" duty of confidentiality -- albeit a duty owed to a corporation seeking to buy shares on the market rather than (as in the usual case) a

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1. *See* 445 U.S. at 238-39 (Brennan. J.. concurring in the judgment). 445 U.S. at 239-243 (Burger. C.J.. dissenting). 445 U.S. at 245-46 (Blackmun. Marshall. JJ.. dissenting).

2. *See* 445 U.S. at 235-36 (majority opinion). 445 U.S. at 237-38 (Stevens. J.. concurring).

corporation whose shares are to be sold. Here, however, the traders did not receive their information from the acquiring corporation, Nytronics, in the course of their duties as officers. Rather, the fact that Nytronics wished to acquire Gulton was publicly known, and Rosenbloom and Selzer were simply recipients of a strategic leak of information from an insider of the target corporation. Thus, I think the misappropriation theory is not apposite here, and it is by attempting to force this case into that particular mold that the majority reaches the anomalous result, noted above, that 10b-5 liability hinges on whether the joint venture or Nytronics used the information.

I believe that, in either circumstance, the investing public that lacks this information is being mulcted. We must, therefore, look elsewhere for a theoretical basis for 10b-5 liability. In certain circumstances, the Supreme Court has held, one who receives nonpublic information from a corporate insider -- a "tippee" -- also acquires a duty to disclose or abstain that "is derivative from that of the insider's duty." *Dirks v. SEC*, 463 U.S. 646, 659 (1983). As the Court stated:

> The need for a ban on some tippee trading is clear. Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain. . . . [A] contrary rule "would open up opportunities for devious dealings in the name of others that the trustee could not conduct in his own."

___U.S. at ____, 103 S. Ct. at 3263-64 (quoting *Mosser v. Darrow*, 341 U.S. 267, 271 (1951)).

Rosenbloom and Selzer were tippees: they received their information from a corporate insider, Dr. Gulton.

who could not have traded on this information himself without disclosing it. Thus. the question remaining is whether. under criteria announced in *Dirks*. Rosenbloom and Selzer also acquired Dr. Gulton's duty to abstain or disclose:

> [A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

Dirks. 463 U.S. at 660. The test as to whether a disclosure by an insider amounts to a breach of fiduciary duty focuses on "objective criteria. *i.e.*.. whether the insider receives a direct or indirect personal benefit from the disclosure." 463 U.S. at 663. "For example. there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter. or an intention to benefit the particular recipient." 463 U.S. at 664.

Under these objective tests. there can be no question but that Dr. Gulton breached his fiduciary duty by tipping off Rosenbloom and Selzer. By giving officers of Nytronics information regarding the intentions of the Gulton board. he almost certainly facilitated the sale of his own shares. because without confidence that it would obtain control of Gulton. Nytronics would have had little interest in Dr. Gulton's shares. Indeed. it appears that the Gulton board may have backed away from the deal out of resentment over Dr. Gulton's self-dealing. and when the deal fell through the price of the shares Nytronics had already purchased fell sharply. Moreover. all of this would have been apparent to any reasonable person in the position of Rosenbloom and Selzer. Therefore. I would hold that

they violated 10b-5 on the theory announced in *Dirks*. This result in no way depends on who was the ultimate beneficiary of the tip.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

IN THE UNITED STATES DISTRICT COURT

FOR THE EASTERN DISTRICT OF PENNSYLVANIA

BENJAMIN ROTHBERG : CIVIL ACTION

vs. :

SANFORD ROSENBLOOM :
and :
DAVID ROSENBLOOM : NO. 83-2387

Philadelphia, Pennsylvania

Wednesday, June 27, 1984

Before: HONORABLE MARVIN KATZ. J.

NON-JURY TRIAL

THIRD DAY

THE COURT: While the matter is fresh in my mind as it is now, I think I will decide it. It will never be fresher in my mind, so that I will decide it by this bench opinion.

This is a suit to recover losses from two bad tips based on inside information. The notes and guarantees sued on here are for the amount of those losses from the two joint ventures.

The business of the two joint ventures was to make and divide secret profits from two tips of inside information. One tip was a company called Nytronics, of which David Rosenbloom was an officer and director, would make a profitable merger with Gulton. Although there was some publicity about the proposed acquisition of Gulton, the key secret information which David transmitted

to the plaintiff was that Dr. Gulton would swing or deliver the votes of the Gulton board to approve the transaction on a stock for stock basis as the Gulton public shareholders, Dr. Gulton having sold his own holdings for cash. David as an insider had a duty to his own corporation not to reveal this key secret to selected persons for the purpose of buying Gulton stock.

For that proposition I would rely on the case of United States versus Newman, 664 F.2d 12, Second Circuit, 1981. The Newman case was a criminal matter.

The purchases on the basis of such inside information would reinforce the feeling of the Gulton board that there was in fact a strong market for Gulton's shares which would make the merger price unattractive at a time when David's

corporation was trying to woo Gulton. Whether or not David breached a duty to Gulton's shareholders, it is sufficient for this purpose that he breached a duty to his own corporation to establish a violation of securities laws under the definitions in the Gulton case.

David misappropriated this inside information for the benefit of the joint venture which produced the losses which are at issue here. The losses occurred because the Gulton board refused to go along with this deal and the tip turned out to be wrong.

The other tip was that a toy company would have banner earnings for a particular year. That tip was based on inside information which David had a duty not to reveal to the plaintiff. The information was based on his factual inside

knowledge of the toy company's activities during the year in question. It was not based upon merely a guess or a prediction.

A reasonable investor in Mallory Randall would consider the information about the 1969 earnings on its Carolina toy subsidiary to be objective, valuable, material knowledge of how much Mallory Randall would earn in the year in question. The only reason the joint venture purchased the Mallory Randall stock was because of David's tip that the Carolina toy company would have a smashing earnings year.

The two joint ventures which lost money for which plaintiff seeks to recover in this case were part of what appears to be a plan for investments on speculations between the plaintiff and David Rosenbloom to make profits from

David's tips based on inside information. Some of the other joint ventures were indeed very profitable. The conduct of plaintiff in financing these joint ventures to profit secretly on tips from misappropriated inside information is of sufficient magnitude to apply in pari delicto under the Tarasi case to protect the purposes of the federal law regulating securities transactions for the benefit of investors. The purpose of letting the parties before me stand where the market left them is to deter others from financing ventures to make secret profits from tips of corporate insiders.

David Rosenbloom knew he could not legally purchase the Mallory Randall stock, which was the subject of the April 18th, 1969 joint venture and the Gulton stock which was the subject of the

May 28, 1969 joint venture. David nevertheless agreed with plaintiff to enter into the agreement with his brother, Sanford Rosenbloom, so that David, Sanford and the plaintiff could secretly profit from David's inside information to know.

Sanford did not know the shares bought by the two joint ventures were purchased on the basis of David's inside information until about the time this suit was brought. David and Sanford did not knowingly and intentionally waive the defense of in pari delicto. More importantly, waiver of the in pari delicto defense in this case would violate the public policy of the securities laws.

The plaintiff and David Rosenbloom knew that the joint venture purchases of the Mallory Randall and Gulton stocks were illegal and based on

David's inside information as an officer and director of Mallory Randall and Nytronics. They intended to profit from these tips and they were of equal fault in setting up joint ventures to profit from material inside information which David misappropriated and disclosed in violation of his fiduciary duties to Mallory Randall and Nytronics. I believe the plaintiff did know the insider information basis for David Rosenbloom's choice of securities which were the subject of these joint ventures.

Mr. Rosenbloom [sic], from my observing his testimony, is an astute, sophisticated and intelligent business-man, extremely careful about detail. David Rosenbloom, from my observing his testimony, is a voluble, limited person, unlikely to keep business secrets and

insensitive to the basic requirements of law regarding the fiduciary duties and legal restrictions imposed upon him as a corporate insider responsible for public investors' money. The combination of Mr. Rothberg's care and interest about the details of his affairs and Mr. Rosenbloom's carelessness about his legal obligations leads me to believe that David Rosenbloom told plaintiff the inside tips which were the basis for the investment decisions of the two joint ventures. I cannot believe that Mr. Rothberg would turn over his investment decisions to a David Rosenbloom.

For these reasons and such others as I may supplement if I review the transcribed record, judgment is entered against plaintiff and in favor of both defendants.

Anything further?

MR. GREENBERG: No, your Honor.

MR. MONTEVERDE: No, your Honor.

(Court adjourned 3:00 p.m.)